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FINANCIAL RESEARCH PROGRAM OF THE
NATIONAL BUREAU OF ECONOMIC RESEARCH

Studies in Consumer Instalment Financing:
Number One

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Personal Finance Companies and Their Credit Practices

BY RALPH A. YOUNG AND ASSOCIATES

Financial Research Program

Studies in Consumer Instalment Financing 1

NATIONAL BUREAU OF ECONOMIC RESEARCH

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Preface

In 1938 the National Bureau of Economic Research inaugurated a broad program of research in finance, under grants from the Association of Reserve City Bankers and the Rockefeller Foundation. The initial project of this program has been a comprehensive investigation of the instalment financing of consumers, an undertaking of which the present study of personal finance companies is one part.

The term "instalment financing" is often used to mean only the financing of retail commodity purchases by instalment payments, but in this investigation we employ it to cover all consumer credit which entails the repayment of principal and the payment of interest in prescheduled amounts at regular intervals. Cash loans on instalment terms, as well as sales finance credit, are therefore included in the area of our study. We have further required, however, that the stated commitment of future consumer income be made under a formal legal instrument providing for definite and prompt legal action in the event of consumer default on a single payment, thus specifically excluding charge account or open book credit, whatever the special arrangements for its liquidation. We have also delimited the area of study by arbitrarily excluding home mortgage credit, because of its highly specialized character and long maturities, although today it is an important form of consumer instalment credit. Thus our definition of consumer instalment credit stipulates on the one hand an instalment basis of repayment scheduled under a formal legal instrument, and on the other hand a relatively short or intermediate term of contract.

Within the area of investigation so delimited a series of studies has been made, the ultimate focus of which is the relation between consumer instalment financing and economic stability. A group of five of these studies deals descriptively with the important agencies and institutions which participate in this type of consumer financing. These five studies were undertaken because there existed no accurate delineation of the credit methods and standards of the several specialized agencies of consumer instalment credit and of their role in financial organization. In addition to the present study of personal finance companies this group includes separate studies of sales finance companies, Morris Plan and other industrial banking companies, government agencies in the field (Federal Housing Administration and Electric Home and Farm Authority), and commercial banks as agencies of consumer instalment credit.

Of the other studies constituting the present project, two are statistical inquiries, undertaken to fill special gaps in the quantitative data on consumer instalment credit, and thus facilitate more accurate judgments regarding its growth and change and also its significance in the contemporary economic structure. One such study presents new estimates of the monthly and annual volume of this type of credit; the other depicts the pattern of consumer debt by income classes and by other social-economic characteristics for a recent year, 1935-36. These studies, in conjunction with those that discuss the institutions of consumer instalment financing, provide the factual setting for our investigation of the relationship between such financing and economic stability. This problem of underlying economic implications is the subject of the capstone study of the project.

The personal finance company, described in this volume, is otherwise known as the "small loan company" or the "licensed lender" since it operates under the sanction of special "small loan" legislation. It specializes almost ex-

clusively in the making of cash loans to consumers, and is one of the principal agencies extending this type of instalment credit.

We are obligated to many individuals and organizations for assisting us in the preparation of this study. The Russell Sage Foundation, well known for its pioneering interest and continuing investigations in the small loan field, generously made its files of state supervisory reports available for our use, and Rolf Nugent, Director of the Foundation's Department of Consumer Credit, gave us the benefit of many suggestions and much technical help. The Consumer Credit Institute of America likewise made its file materials available, and its economist, Margaret Grobben, aided us in many ways. A number of state supervisors furnished information in response to our inquiries. We are under special obligation to the three largest companies in the personal finance business, the American Investment Company of Illinois, the Beneficial Industrial Loan Corporation and the Household Finance Corporation. All three companies have made available to us statistical data covering their operations, and their officers have supplied information on various phases of the business and given us many technical suggestions and criticisms. The extent to which we rely on data from these three companies is abundantly evident from the text. We are particularly indebted to the officers of the Household Finance Corporation for making available to us their company's extensive internal studies dealing with credit experience in personal finance lending.

For criticisms of the manuscript we are indebted to the research staff of the National Bureau. Other readers whose critical suggestions have been helpful include Burr Blackburn, Household Finance Corporation; Fred H. Clarkson, Consumer Credit Institute of America; LeBaron Foster, Pollak Foundation; Wilfred Helms, Household Finance Corporation; David Lichtenstein, American Investment

Company of Illinois; M. R. Neifeld, Beneficial Industrial Loan Corporation; W. W. Riefler, Institute for Advanced Study; Roland Robinson, Division of Research, Board of Governors of the Federal Reserve System; William Howard Steiner, Brooklyn College; Theodore Yntema, University of Chicago. We have been aided too by the counsel of many bank credit officers who have had long experience in extending bank loans to personal finance companies, and our obligations to Arthur W. Newton of the First National Bank of Chicago are particularly great. To Frank B. Hubachek, counsel for the Household Finance Corporation, we owe a special acknowledgment for his careful checking of our tabulation of small loan legislation and for his many technical criticisms of our manuscript.

This study has taken final form only as a result of the collaborative efforts of several members of the Financial Research staff; each has made a special contribution, and each has been indispensable to the whole.

Eli Shapiro was responsible for the statistical tabulations presented in Chapters 1 and 5.

Ralph Wood made the initial studies which formed the basis of Chapters 2, 3 and 4, and assisted in preparing other sections of the study.

David Durand made the study of customer charges that is contained in Chapter 6.

Raymond J. Saulnier prepared the study of the effects of legal rate changes in Chapter 7 and also the analysis of relations among lenders presented in Chapter 8, as well as collaborating in other parts of the study.

Isabel L. Davis prepared the original draft of the summary, and assisted in editing the first draft of the manuscript.

Elizabeth Todd was in full charge of editing the manuscript for publication.

George W. Blattner, who served as Director of the National Bureau's Financial Research Project during 1938, was re-

sponsible for the initiation and direction of the studies in the field of consumer instalment financing from the inception of the investigation until his illness in the fall of that year. Those of us who were associated closely with him in the formative stages of the various studies included in this project owe him a special debt of gratitude for his cordial assistance in all phases of our work.

RALPH A. YOUNG, *Director*
Financial Research Program

December 1939

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Summary Survey

THE personal finance business as it exists today has grown out of legislative attempts to combat the loan-shark evil, which had arisen because the usury statutes prevented the profitable lending of small sums at legitimate rates. In 39 states, the District of Columbia and Hawaii laws are now in effect which regulate this business. Licensed lenders are granted statutory permission to make one over-all charge, including interest, at a rate not to exceed a certain specified percentage. The maximum legal rate ranges in general from 2 to 3½ percent per month, computed on the unpaid balance of the loan, and in most states $300 is the largest amount that may be lent on these terms. The principal is repaid in equal instalments over a specified period, varying mainly between 5 and 20 months.

THE SIGNIFICANCE OF PERSONAL FINANCE COMPANY CREDIT

The volume of personal finance company receivables has increased in the last two decades from about $20,000,000 to nearly $400,000,000 (including about $50,000,000 of interest due and to become due), held at the end of 1937 by licensed lenders in 27 states; this estimate represents about two-fifths of the consumer loan receivables of all cash-lending agencies at that date. During the period 1933-37 probably between 17 and 23 percent of all the non-farm family and individual income-receiving units in the country obtained credit accommodation from personal finance companies. Approxi-

mately 3,000,000 individuals, concentrated in somewhat more than half the states, are estimated to have been borrowers from licensed lenders in 1937.

Between cash loan and sales finance credit—the two major types of consumer instalment credit—there are important differences. Sales finance credit is invariably associated with the transfer of a commodity, while cash loan credit, although often used for the purchase of a commodity, is sought for many other purposes as well. Personal finance companies, unlike sales finance companies, deal directly with the borrower, extend only cash loans, state aggregate charges usually as a percent per month of unpaid loan balance, and for security rely chiefly on the character of the borrower. A basic legal distinction exists in the matter of charges: those of sales finance companies are not interest within the legal meaning of the term, and may therefore be determined by a process of bargaining, but those of cash lenders are subject to statutory regulation. The total volume of credit extended by personal finance companies is much smaller than that extended by sales finance companies—probably only about one-third as great.

The differences between personal finance companies and other cash-lending agencies are much less marked. Industrial and Morris Plan banking companies, and the personal loan departments of commercial banks, are in many ways the closest rivals of personal finance companies in the consumer cash loan field. The banks, however, make loans up to $2000 or more, as compared with the usual $300 limit set for personal finance companies, and they tend to charge lower rates. Credit unions and remedial loan societies, the other cash-lending agencies, are relatively unimportant in volume.

The leading industrial and semi-industrial states show the largest concentration of lending activities; 9 of them accounted in 1937 for more than three-fourths of the receivables of personal finance companies and for almost three-

fourths of the licensed loan offices. The density of loan offices per 100,000 of population varied in that year from 0.2 in Tennessee to 9.1 in Colorado; available information indicates that facilities are almost non-existent where maximum legal rates of charge are relatively low, and that where the small loan law allows state authorities to restrict the number of licensees facilities are less numerous than in other states. The availability of credit facilities does not, however, indicate the extent to which they are used by consumers. This may be estimated from outstandings per 100,000 of population; in many states there is no direct relationship between the availability and the utilization of facilities.

Most state laws governing personal finance companies are modeled on the Uniform Small Loan Law, first drafted in 1916 by the Russell Sage Foundation, which has pioneered in such legislation. This model law has been revised at intervals, and in its sixth and latest draft, published in January 1935, it continues previous provisions regarding size of loan, licensing, supervision, relations with borrowers, penalties and exemptions, but suggests a graduated instead of a fixed maximum rate. On December 1, 1939, small loan legislation in 34 states, the District of Columbia and Hawaii resembled the model law; in 5 states it differed widely from the model. Even in the former group, however, the statutes of the various states were not equally effective in achieving their purposes.

Personal finance offices may be operated by individuals, partnerships or corporations. The corporate form has become increasingly important with the rise in chain lending. At the end of 1937 the two largest chain companies held almost 40 percent of the reported outstandings of all personal finance companies in the country. Chains enjoy certain operating advantages, but independent lenders, especially in some localities, are able to compete with them effectively.

At first personal finance companies obtained their funds

largely from the investment of individual entrepreneurs, later from reinvestment of earnings, then from the marketing of stocks and bonds, and finally from the short-term money market. Today these companies have access to all leading credit facilities—a change, apparent even since 1929, which indicates their increasing recognition as established credit agencies. Especially the chain companies make use of short-term borrowing as a source of funds, obtaining credit from commercial banks and also selling notes in the open market. Data applying to Indiana, the only state for which comparative figures are available, indicate that independent individuals and partnerships depend less on borrowed capital than do other forms of personal finance company organization.

THE LOAN AND ITS MARKET

Personal finance loans are made in any amount up to the legal limit, which is usually $300. The average size of loan varies in different states, depending somewhat on the extent of the region's industrialization and on the height of the maximum legal rate of charge: in agricultural and semi-industrial states, and in states that permit a charge of 3½ percent per month, the average loan is usually smaller than it is in industrial states and in those that allow a charge no higher than 2½ percent. While the available data are not conclusive, they indicate that the average loan has been increasing in size for a number of years, running currently, for the country as a whole, a little less than $150.

Most loans are repayable over a period of 5 to 20 months. But because many borrowers arrange new loans in order to liquidate existing balances and to obtain additional sums, the actual life span of an individual loan is typically, according to data from one large chain company, between 8½ and 12 months, while the total period of customer indebtedness is usually 26 to 29 months.

Loans are most frequently secured by chattel mortgages, although the use of the unsecured note is increasingly prevalent, amounting in a number of states to 10 to 30 percent of all loans extended. Use of the endorsed and the comaker note varies considerably in different states. Loans on wage assignments are rare, except in Illinois.

Personal finance companies draw their customers almost entirely from urban residents whose annual incomes are between $500 and $3500, a range which contains over three-fourths of the non-farm income-receiving units of the country. The experience of three chain companies, which together handle about half the dollar volume in licensed small loans, indicates that three-fourths of all loans made by personal finance companies are to borrowers with annual incomes between $1000 and $2500. In general, customers whose monthly incomes are below $200 obtain loans approximately equal to, or somewhat greater than, one month's income; those receiving $200 or more obtain loans somewhat smaller than one month's income.

Although borrowers from personal finance companies are drawn from a variety of occupations, the wage-earning and clerical groups constitute the major source of demand. According to data from the same three chains, these two broad groups provide roughly three-fourths of the customers for personal finance credit, a proportion about equal to, or possibly a little higher than, the representation of these occupations among all non-farm, non-relief families in the country. Business and professional groups are next in importance as borrowers; farmers constitute a very minor source of demand.

Any classification of loans according to reasons for borrowing or intended use of funds must be based on borrower statements made at the time of loan application, and is therefore somewhat arbitrary. Available data give some indication, however, of the types of maladjustment between income and expenditure which most frequently necessitate borrowing.

The records of one large chain for 1933-37 show that about half the loans were made to meet "an unusual large expenditure," and more than a third were needed because the borrower had failed to provide for periodic expenses. About 6 percent were due to emergencies such as illness or unemployment.

Data from three large chains on the intended use of borrowed funds indicate that more than one-sixth of all loans are applied to the basic living expenses which are represented by non-durable consumer goods, and that almost the same proportion are applied to medical and funeral expenses. Refinancing is the purpose of a significant proportion of all loans—a proportion ranging from 25 to 75 percent according to the classifications used. Finally, a small percentage of loans are used for business purposes, indicating that no sharp distinction can be drawn between producer and consumer credit in personal finance lending.

OPERATING METHODS AND COLLECTION EXPERIENCE

Personal finance lenders actively solicit loan applications from former borrowers, and also applications from present borrowers for additional sums. Well over half of all applicants come from one of these groups. New customers are sought too, of course, through advertising and special inducements of various kinds, but their applications are accepted in much smaller proportions than are those of present and former borrowers. In their selection of customers lenders also attempt to diversify their risks, both occupationally and geographically. The need for diversification is, in fact, one reason for the growth of chains, and distribution of risks was probably a factor in the relative stability of the earnings of personal finance chains throughout the depression years.

The basic staff for a loan office consists of a manager, an

outside man and a clerk; such a staff can handle about 750 loans, representing outstandings of as much as $100,000. A minimum volume of $50,000 is regarded as essential for a chain office to operate profitably. Chain operation necessitates centralized control and uniform training of personnel.

Successful operation of a personal finance company requires that at least ninety-five out of every hundred loans pay out, and that delinquency be kept at a minimum. Therefore the detection of dubious risks is a vital factor in credit administration. The procedure involves a private interview by the manager, during which the first selection is made. A not insignificant proportion of applications are refused at this time, without further consideration—14 percent, according to the experience of one chain company in the period 1933-37. All applicants that are considered eligible are carefully investigated through various channels, this procedure being greatly facilitated when the applicant is a present or former customer.

On some delinquent loans payments are overdue on both principal and charges, and on others the tardiness is on principal payments alone. The extent of both types of delinquency has been estimated at 15 percent (the ratio of unpaid principal on all delinquent accounts to unpaid principal on all outstanding accounts). Figures which exclude "delinquency on principal only" show wide variation, ranging from 3 to 14 percent in 1937 for 15 states for which data are available.

When borrowers cannot meet payments due, or when they seek additional funds before a loan is paid off, refinancing is often arranged, the new contract usually having the same terms as the original. "Renewal" loans—those that are refinanced without the provision of new funds—are rare, but the extension of new funds to present borrowers is a highly important source of business. Foreclosure on chattel mortgages is seldom resorted to, because this practice alienates community goodwill, and the amount realized from the sale

of chattels almost never covers the unpaid balance outstanding.

Data from two chain lenders indicate, as would be expected, a fairly close relationship between trends in delinquency experience and in bad-debt loss. For one of these lenders over 40 percent of the accounts charged off in 1937 had been delinquent 90 days or more on both principal and charges. The length of delinquency at the time of charge-off is somewhat less when delinquency is measured, as in this figure, from the last date on which at least some payment was received, than when it is measured from the last payment of charges plus half the principal instalment due; this is because payments typically fall off before they cease altogether.

Bad-debt losses in the years before 1929 have been estimated at less than 2 percent of total outstandings for chattel lenders, and less than ½ percent for endorsed-note lenders. During the following depression years these losses rose sharply, but substantial recoveries on charged-off accounts were subsequently made.

Though small in proportion to total loans, bad-debt losses form a substantial part of the operating expenses of personal finance companies. Data covering all states for which such figures are available show that bad-debt losses of all reporting personal finance lenders averaged 10.3 percent of total expenses in 1929, 22.7 percent in 1932 and 10.6 percent in 1936.

A special analysis of a large sample of loans made by one chain, according to the method of their termination, gives a clear summary of trends in the collection experience of personal finance companies. Only about 1 percent of the loans were terminated by charge-off, and a substantial proportion were fully repaid in cash; in fact, repayment before scheduled maturity was not at all uncommon. The majority of the loans, however, were terminated by a new loan—nearly three-fifths

of those to new and former customers and three-fourths of those to customers who were already repeat borrowers. This is striking evidence of the importance of present customers as a steady source of demand for the credit extended by personal finance companies.

CREDIT STANDARDS

The personal finance lender must choose carefully among potential borrowers in order to avoid costly collection problems. In each case his decision depends partly on certain intangible factors, not capable of statistical measurement, but it depends also on certain characteristics of the borrower and of the loan contract which are capable of empirical analysis in relation to charge-off experience. Our analysis of these latter indicators of credit risk is based on the charge-off experience of one large chain lender between 1933 and 1937. The data naturally reflect the lending policies of this particular firm and therefore are not necessarily typical of the experience of the entire trade, but they are based on a large volume of business and they are fairly representative of certain central factors in credit risk for this type of lending.

During the period 1934-37 charge-offs on loans to new customers, who constituted about one-fourth of all borrowers, were more numerous than average. Former customers, about one-seventh of the total, were by far the best risks, but present customers (those who refinance an unpaid balance and receive additional funds) were numerically far more important than any other group, and they too had a better than average record. Loans to renewal customers (those who refinance an existing balance but receive no additional funds) were very few, and they showed the highest relative number of charge-offs.

More than four-fifths of all loans made during 1936 and 1937 were secured by household goods, and these loans had a charge-off record well above average. Unsecured loans, with

the exception of those to teachers, showed the least favorable credit record. Teacher loans, constituting about 6 percent of the total, were easily the best risks; even when teacher loans are charged off, the balance owed is a smaller proportion of the original loan than it is in the case of charge-offs of loans to non-teachers. These facts lend support to the general practice among personal finance companies of viewing schoolteachers as preferred risks.

In the period 1934-37 one out of every three borrowers had a monthly income of $100-150; the average loan to this group was $152, and its credit record was very slightly poorer than average. About one-sixth of the borrowers received incomes lower than this, and they showed notably poorer credit records. In fact, charge-off experience improved in direct relation to the income of the borrower; this is readily understandable since payments absorb a larger proportion of the monthly income of borrowers in the lower brackets, and also impinge to a greater degree on basic living requirements.

The stability of a borrower's income may be even more important than its size, and this factor in credit risk may be evaluated to some extent by the borrower's occupation and the industry with which he is affiliated. During 1933-37 charge-off experience was worse than average on loans to proprietors, unskilled workers and salespersons; it was better than average on loans to skilled and semi-skilled workers, managers, superintendents and foremen, schoolteachers and others in professional pursuits, persons with independent incomes, and office and clerical workers. Over this period of general recovery there was a tendency for collections from unskilled workers and professional persons (other than teachers) to become relatively better, and for those from salespersons and office and clerical workers to become relatively worse.

As to the borrower's industrial affiliation, in 1933-37 postal service, telephone and telegraph, agricultural, railroad and

streetcar, public and professional service, and iron and steel groups provided the most desirable credit risks, while mining, truck and taxicab, domestic and personal service, building and construction, food manufacture, and wholesale and retail trade groups accounted for the poorest credit risks. The records of most of these industries were consistent throughout the period.

In general, charge-offs vary directly with the size of loan, but the trend is broken at the $300 loan class, which included about 20 percent of the total number and 36 percent of the dollar volume of all loans made in the period 1934-37. These $300 loans showed a record only slightly poorer than average, and markedly better than that of $250-300 loans, possibly because a higher than average proportion of $300 loans are made to borrowers with higher incomes and to members of those occupational groups that typically provide the better risks. It seems likely, however, that size of loan is no more than a secondary determinant of credit risk, for its significance is notably contradicted in the data on certain other factors in relation to charge-off experience.

A special classification of charged-off accounts according to whether they were suspect at the time the loans were made reveals that among all except new borrowers the likelihood that a doubtful loan will be charged off is at least five times as great as that for a loan that was considered sound when made. But in this as in other findings concerning credit risk it should not be inferred that all worse than average credit risks should be refused. It is likely that on the whole the additional income they provide is greater than the additional costs that they entail.

EXPENSES AND INCOME

By far the major source of personal finance company income is the charges collected on loans, which in 1937 averaged 97.5

percent of the gross income of licensed lenders in 15 states. The balance was derived from collections on accounts previously charged off (2 percent), interest on bank balances, authorized fees and "other income." Expressed as a percent of "average employed assets," gross income declined steadily from 28.6 in 1929 to 26.0 in 1933, but improved to 27.3 in 1936.

A distribution of expenses, representing averages for 1934-36, shows that salaries made up almost 40 percent of total expenses (not including interest on borrowed funds), that bad debts and insurance against loss constituted about 13 percent, and advertising about 11 percent. Total expenses, exclusive of interest, averaged about 18 percent of average employed assets in the years 1929-36, with bad debts and insurance showing the greatest variation of any of the individual items during this period. The data that are available on money costs as an item of expense suggest that variations in interest rates on borrowed funds have a relatively slight effect on total expenses, and are therefore of minor significance as a determinant of charges.

Net income as a percent of average employed assets, obtained by subtracting the percentage for total expenses from that for gross income, does not show actual return on investment but when calculated for a several-year period it does indicate the magnitude and direction of fluctuation in profits. It is interesting to note that during 1929-36 net income ranged from about 7 to 12 percent of average employed assets; it was highest in the first three years of this period, lowest in the next three years, and steady at about 9 percent during 1935-36.

The relationship between size of office and profitability may be examined for the two industrial states, Illinois and New Jersey. In 1937 net return tended to vary directly with size of office, both of them measured by year-end employed assets. This indication that definite operating economies are

associated with larger volume is confirmed by the fact that there was a general tendency not only for gross earnings to be higher for larger offices but also for total expenses in percent of gross earnings to be lower. In view of the greater profitability of the larger offices it is not surprising to find that they control a substantial share of the personal finance business in these two states.

Data for various types of lenders in the state of Indiana show that chain lenders have, on the whole, the largest offices, enjoy the highest ratio of gross earnings to total employed assets, and show a lower ratio of expenses to earnings than any other type except partnerships; the latter, though second smallest in average size, have the lowest expense ratio and the highest net return on employed assets. While variations in lending policy and in accounting practices may cause some of the differences observed among the various types of Indiana lenders, it seems reasonable to assume that chains occupy a comparatively favorable profit position, especially in view of the corroborative evidence from the analysis of office size.

RATES OF CHARGE

In any state the maximum legal charge on personal finance company loans is not necessarily the charge made by all lenders, but the various legal maxima are representative of the types of rates that are quoted. At present 13 states and the District of Columbia set as a maximum a flat monthly percentage of the unpaid balance of the loan; the per annum equivalent of such a rate is of course twelve times the monthly rate, and this latter percentage times the average outstanding balance gives the total dollar charge for one year. In 14 states and Hawaii the maximum legal charge is a combination of one rate on the unpaid balance up to a specified figure and a lower rate on the remainder, a form of quotation which is

suggested in the latest draft of the Uniform Small Loan Law. One state, Missouri, provides for a combination rate of this type graduated according to the original size of the loan rather than according to the unpaid balance. A rate which provides for a regular interest charge and, in addition, for certain stipulated fees, is permitted in a few states. Such a rate, and also the combination rate, makes it difficult for the borrower to compute total charges per year, either in percentage or in dollar terms.

There has been much controversy as to the ideal form of rate schedule, some experts favoring the flat percentage rate, because of its simplicity, and others contending that rates should be adjusted in such a way as to reflect the actual costs incurred in various typical circumstances. No adequate studies have been made, however, on the actual costs of various types of loans. Available studies classify total costs according to several all-inclusive categories (such as investigation cost, carrying cost, capital cost) and calculate from this the average cost per loan. Such a computation gives results which make it clear why lenders consider very small loans, and loans repaid within a very short time, as unprofitable under a flat rate of charge, but as a meaningful treatment of costs it has serious shortcomings. First, there are several cost items which do not fit into any convenient category and must be allocated according to an arbitrary standard. And second, the very concept of average cost makes it necessary to ignore such significant variables as size and duration of loan, size of office, type of borrower, and nature of the security. Nor is average cost a reliable determinant of lending policy. If the lender's facilities are not fully utilized he may find it expedient to make loans of a type which, according to the criterion of average costs, would be unprofitable at existing rates; in other words, his average cost may be reduced by the additional volume of business.

THE EFFECTS OF CHANGES IN MAXIMUM LEGAL RATES

To support their contention that if licensed credit facilities are to be provided to low income groups legal rates must be high enough to encourage profitable operation, lenders often cite the experience of states that have drastically changed the maximum rate provisions of their small loan laws. Data are not available for a complete analysis of the effects of such changes, but fairly complete information is available for 5 states.

In New Jersey the maximum legal rate was reduced, effective February 15, 1930, from 3 to 1½ percent per month. Between 1929 and 1931 there was a sharp drop in the number of licensed lenders and in the amount of loans outstanding, while the size of the average loan increased substantially. During this same period the personal finance business in Massachusetts, a state similar to New Jersey in its economic structure, and also licensed lending in the country as a whole, showed the opposite trend; it therefore seems probable that these New Jersey changes cannot be attributed to general economic conditions.

In 1932 the law was amended, raising the maximum legal rate to 2½ percent per month. Thereafter the volume of outstandings rose sharply and the average size of loan decreased, while both remained fairly constant in Massachusetts. There was only a slight rise in the number of loan offices in New Jersey, but this may be explained by certain provisions of the amended law regarding the size and number of offices.

A rate reduction from 3½ to 2 percent per month was in effect in West Virginia from 1929 until 1933. Here too the period of lower rates showed a great decrease in the number of licensees and in loans outstanding, a decrease far out of proportion to that in the country as a whole, and there is some indication that the situation encouraged illegal lending.

In the middle of 1933 an amendment became effective which raised the maximum rate from 2 percent to 3½-2½ graduated at $150 and, as in New Jersey, making certain stipulations as to the size and number of offices. Subsequently both the number of licensees and the amount of loans outstanding increased far more than in the country as a whole.

Georgia reduced its legal maximum in 1935 from 3½ to 1½ percent per month and this rate is still in effect. By 1937 licensed lenders had practically disappeared from the state, and various forms of illegal lending are said to have developed.

The Tennessee rate change, which took effect in February 1937, amounted to a reduction from 3½ to 1½ percent per month. It is estimated that since that time the number of licensed lenders operating in the state has decreased by almost 90 percent, and that the capital invested in the industry has decreased 95 percent. In a single year after the rate change the volume of loans fell 87 percent.

The Missouri rate reduction—from 3½ to 2½ percent per month—became effective in August 1929. Not only was the reduction less severe than any of the others, but when it occurred the Missouri small loan law had been in operation for only two years and the industry was still expanding rapidly; thus the effects of the change were somewhat different from those in the other states. The number of licensees fell sharply but the volume of loans outstanding remained about the same for two years, decreased somewhat during the next two years of general business depression, and by 1937 had almost regained its 1929 level. Immediately after the reduction the average loan became larger, but then tended to decline in size. Late in 1939 the law was modified to increase the rate to 3 percent on loans of $100 and less.

Even with due allowance for the fact that rate changes cannot be examined apart from the specific conditions prevailing in the state, it appears reasonable to draw a few broad con-

clusions as to the effects of such changes. After a rate reduction many licensed lenders go out of business or move to neighboring states, and there is evidence that illegal lenders increase in number. There is also a decrease in the volume of outstanding loans. The average size of the loan offices that remain shows no conclusive trend, perhaps partly because of insufficient data, but available information suggests that fewer small-size loans are made. A rate increase, on the other hand, appears to be accompanied by a rise in the number of licensed lenders and in the volume of loans outstanding.

RELATIONS AMONG LENDERS

Cooperative relations among personal finance companies have developed from the need to initiate and maintain special permissive legislation, and also from attempts to foster the demand for small loans, to protect the interests of lenders, and to supply to one another the services which can best be provided by concerted action. There is one national organization in the business, the American Association of Personal Finance Companies, located in Washington, D. C.; its membership comprises about a third of all reported licensees, and represents three-quarters of the total volume of outstanding loans. The main purpose of the Association is to elevate the standards of business conduct in the trade and to promote a more favorable public attitude toward licensed lending. Direct services to its members include the publication of a monthly magazine and of an annual roster of licensees, and also the provision of advertising information and other advice on lending practices. Through its National Council the Association maintains contacts with the 27 voluntary state associations; the latter represent their members at legislative hearings and otherwise perform much the same functions as the national association. Local organizations function chiefly for the exchange of credit information, and sometimes serve as collecting agencies.

Competition among licensed lenders is reflected mainly in the terms which they quote to borrowers. The upper limits to the rates they may charge is set by the small loan laws, but competition may bring quoted rates below this level and ease other terms of the contract; it may also determine the amount of money that a company will lend to any one borrower. Small competitive rate cuts are not likely to cause borrowers to shift from one lender to another, although substantial rate cuts may do so.

Competition between personal finance companies and other consumer credit agencies is becoming increasingly important. The trend is for all such agencies to diversify their activities, and a complicated situation has thus been created wherein companies that might serve fairly distinct markets find themselves offering practically the same services to the same potential customers.

Finally, in states where maximum legal rates are low, licensed lenders meet competition also from unlicensed lenders, particularly on middle-size loans, and from licensed lenders in neighboring states where higher legal charges make possible a less restricted lending policy.

The natural limitations of the small loan market serve to restrict competition to some extent, and in some states supervisory authorities are empowered to limit the number of offices in a single community. It is quite possible, however, that a few large offices with high operating efficiency may mean a more competitive situation than many small offices. Competition, not only among personal finance companies but also among all consumer credit agencies, would undoubtedly be stiffened if they all quoted rates on a uniform basis; with the present variation in the methods of rate quotation it is difficult for the borrower to compare the prices he must pay for the various kinds of credit available to him.

1

The Significance of Personal Finance Company Credit

THE modern personal finance company specializes in small cash loans, usually limited to a $300 maximum. Repayments on principal, made in equal instalments, generally extend over a period of 5 to 20 months, although the loan period is gradually being extended to cover a period of 4 to 30 months. The business originated in legislative attempts to combat the loan-shark evil, and is conducted under statutory permission to make one over-all charge, including interest. Such permission is granted only to lenders who submit to license requirements and conform to regulations provided for the borrower's protection. Laws designed to permit the personal finance business, subject to regulations, have been enacted in 39 states, the District of Columbia and Hawaii. The latter two jurisdictions and 34 of the 39 states have laws resembling the Uniform Small Loan Law, a model draft first published by the Russell Sage Foundation in 1916 and subsequently revised at intervals. The Foundation has played an important part in developing and sponsoring legislation in this field.

In those states in which the personal finance business is authorized the maximum rate of charge ranges, for the most part, from 2 to 3½ percent per month, computed on unpaid balance. These rates are either a fixed monthly percentage or a graduated charge with one rate applying to the first $100 or $150 of unpaid balance and with a lower monthly rate applying to the remainder. The percentage rate represents

an all-inclusive charge, covering the entire cost of the loan to the borrower.

The rise of personal finance companies reflects the need for credit facilities which will help consumers to finance unusual personal and family expenditures. The borrower may seek this type of financing either because of an accumulation of many small debts or because of a large expenditure which he is unable or unwilling to meet from a single paycheck or from savings. By borrowing in this way he is enabled to make a series of small regular payments from current income, and to spread them over a period of many months. This kind of credit was available before the rise of the personal finance company, but at exorbitant rates and without legal sanction.

QUANTITATIVE IMPORTANCE OF PERSONAL FINANCE COMPANY CREDIT

The significance of personal finance lending in the modern credit economy is indicated both by the volume of consumer debt to which it gives rise and by the number of individuals who avail themselves of small personal loans. Volume figures covering reporting licensed lenders in 27 of the states whose legal enactments resemble the Uniform Small Loan Law show total small loan receivables outstanding at the end of 1937 of about $338,000,000.[1] This figure, however, represents only the face amount of unpaid loan balances outstanding; it excludes interest due but not received, and interest to become due before the expiration of the current loans. If comparison is to be made with similar figures for other consumer instalment credit agencies, these items must be included.[2] We estimate that $47,000,000 to $54,000,000 should

[1] See Table 1.

[2] In the personal finance business customer notes cover only principal borrowed; interest is charged at inclusive monthly rates. In other fields of consumer credit, such as sales finance and personal loan credit from industrial banks and commercial banks, customer notes cover principal borrowed plus

be adequate to cover interest due and to become due.[3] The total personal finance debt may therefore be set at $385,000,000 to $392,000,000. The consumer loan receivables of all cash-lending agencies combined may be set provisionally at approximately $900,000,000 as of the end of 1937; thus the personal loan companies held a little over two-fifths of the total. This volume of receivables of licensed personal finance companies has been built up over a relatively short span of years; two decades ago probably less than $20,000,000 was outstanding in licensed small loans.[4]

According to available data about 3,000,000 individuals, or approximately 9 percent of the estimated total of non-farm family and individual income-receiving units in the nation,[5] were borrowers from personal finance companies at the end of 1937.[6] Probably as many as 17 to 23 percent of all non-farm family and individual income-receiving units in

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finance charges. Instalment receivables outstanding in these other fields therefore contain a finance charge debt as well as a debt on unpaid principal account.

[3] The "interest due and to become due" item has been estimated from the formula $oi\frac{(d+2)}{3}$, in which o is outstandings, i is monthly interest rate, and d is duration of loan. According to information supplied by Rolf Nugent, Director of the Department of Consumer Credit of the Russell Sage Foundation, the average duration of personal finance loans approximates 15 months, and the average rate of charge is 2.8 percent. Using Nugent's figures in the above formula, we get $53,700,000. If instead of Nugent's figure of 15 months duration we use 13 months—a figure obtained for several states from a collections ratio (outstandings divided by average monthly collections)—we get $47,300,000 instead of $53,700,000. These two figures, then, give the estimated range within which the true value of interest due and to become due probably lies.

[4] Rolf Nugent, "Small Loan Debt in the United States," *Journal of Business*, University of Chicago, vol. 7, no. 1 (January 1934).

[5] The total number of family and individual income-receiving units of the nation for 1935-36 is estimated by the National Resources Committee to be 39,458,300 (*Consumer Incomes in the United States*, 1938, p. 6). From this total we exclude farm non-relief families, numbering slightly over 6,000,000, because only an insignificant fraction of personal finance company borrowers come from this group.

[6] As estimated by M. R. Neifeld of the Beneficial Management Corporation in *Personal Finance Comes of Age* (1939) p. 138.

the country obtained credit accommodation from personal finance companies during the period 1933-37.[7] Since in many states lack of permissive legislation precluded access to the services of licensed lenders, the states having legalized lending contained, of course, an even greater proportion of nonfarm income receivers using personal finance facilities over this period. In fact, the 3,000,000 or more borrowers from licensed lenders at the end of 1937 were concentrated in somewhat more than half the states, including the more populous industrial states, most of which have enacted comprehensive small loan laws.

PERSONAL FINANCE AND OTHER CONSUMER INSTALMENT CREDIT

The two principal types of consumer credit extended on instalment or serial repayment terms are cash loan credit and sales finance credit.[8] They cannot be contrasted, as is often done, on the ground that only the latter is concerned with a commodity transfer to a final consumer. It can only be said that sales finance credit is invariably associated with such a transfer, while cash loan credit, including personal finance, although often extended for the immediate purchase of commodities or services, is sought for many other purposes as well.

The essential feature of sales financing is an advance of credit for the purchase of a specific commodity, the resale value of which serves as technical security for the loan. The first extension of credit is by the retail dealer who, in effect, lends to the customer an amount that equals the selling price of the commodity plus charges for the credit—and possibly

[7] In relating the number of borrowers to the number of families plus single individuals, we are assuming that the number of instances in which two or more borrowers come from the same family is insignificant.

[8] See National Bureau of Economic Research (Financial Research Program), *Sales Finance Companies and Their Credit Practices,* by Ralph A. Young and W. C. Plummer (ms. 1939).

plus costs of insurance against theft or damage—minus the required down payment. The retail dealer often sells the instalment purchase contract to a sales finance company, and the customer undertakes to pay off his indebtedness according to a specified schedule of equal—ordinarily monthly—instalments. There has been no transfer of cash between the purchaser and the seller, but the former has, in effect, obtained an article by means of a loan.

The making of cash loans is the primary activity of personal finance lenders licensed under small loan laws. Many of these cash loans are used to purchase commodities, and a considerable number of personal finance companies actively encourage borrowing for this purpose. The chief features that distinguish personal finance from sales finance companies are that they deal directly with the borrower, extend only cash loans, state their aggregate charges usually as so many percent per month of the unpaid loan balance, and extend loans chiefly upon the "character" of the borrower, taking a chattel mortgage or other security primarily for psychological effect. Sales finance companies, on the other hand, do not ordinarily negotiate directly with ultimate consumers; they state their charges in many different ways that do not permit of ready comparison; and as security for the credit extended they value their equity in the commodity serving as collateral more highly than do personal finance companies.

There is, moreover, a basic legal distinction between the two types of credit. Under traditional legal doctrine any charge to an individual debtor for the use of borrowed money is interest, and is therefore subject to possible statutory regulation of interest rates. But the special charge imposed by sellers on instalment buyers is not interest within the legal meaning of the term; it is rather a differential charge added to the cash selling price to compensate the seller for the special costs, inconvenience and risks incurred in a credit

sale.[9] Thus in sales finance transactions buyers and sellers of commodities are free, so far as usury laws are concerned, to determine mutually acceptable finance charges by a process of bargaining, while cash lenders must conform in their charges to regulative statutes. The situation may change, however, when instalment purchase contracts are readjusted or extended in order to bring them within the purchaser's ability to pay and thus avoid default and repossession. New contracts to refinance instalment purchase deals are regarded by many sales finance companies as money loans, and hence as governed by statutory interest provisions.[10] In order to take advantage of the higher interest charges permitted under small loan laws, a number of sales finance companies operate licensed small loan affiliates whose business is primarily derived from the refinancing needs of instalment buyers.

Quantitatively the credit extended by sales finance companies is much more important than that extended by personal finance companies. The amount of instalment loan paper held by the licensed personal finance lenders is probably less than a third of that held by sales finance companies. While total outstanding consumer debt to personal finance companies approximated $385,000,000 at the end of 1937, a group of 224 automobile finance companies, whose business does not cover the entire field of automobile financing, held then over $1,000,000,000 in instalment receivables.[11] The inclusion of furniture, radio, refrigerator and other paper held by sales finance companies would swell the total considerably.

[9] Although charges made by sales finance companies are not now generally subject to usury laws, there is of course nothing in traditional legal doctrine to prevent regulation of the sales finance business.

[10] Legal doctrine in this matter is in a state of flux. According to a ruling of October 15, 1936, by the Indiana State Department of Financial Institutions, charged among other activities with the regulation of retail sales financing, a partially unperformed contract "may be modified by the agreement of the parties to extend the time and manner of payment so long as the finance charge is not more than it would have been if the contract had originally been entered into for the longer period."

[11] According to a Bureau of the Census release dated February 14, 1939.

Personal finance companies are not the only agencies extending small cash loans on an instalment basis. Morris Plan and other industrial banking companies, personal loan departments of commercial banks, credit unions and remedial loan societies are the principal other agencies of this type. Remedial loan societies were originally semi-philanthropic agencies, but several of them are now strictly commercial ventures; they make loans at comparatively low rates of charge, but their resources at present suffice to meet only a very small fraction of the consumer credit demand which responds to such low rates. Credit unions are cooperative societies with rates also relatively low and with resources derived largely from member deposits. Their loan volume is much smaller than that of any other cash-lending agency except remedial loan societies. Industrial and Morris Plan banking companies and personal loan departments of commercial banks are in many ways the closest rivals of personal finance companies in the consumer cash loan field. In types of service both compete, in greater or less degree, with personal finance companies, but while the latter are usually restricted to a maximum loan of $300, industrial and commercial banks make consumer loans up to $2000 and more. The banks charge lower rates than those of personal finance companies, but they average larger loans and they draw borrowers from more secure and more stable economic classes.

GEOGRAPHIC DISTRIBUTION OF PERSONAL FINANCE COMPANY FACILITIES

The scope of personal finance company operations in 29 of the 34 states that have enactments resembling the Uniform Small Loan Law is shown in Table 1, which gives the number of licensees and the volume of reported outstandings at the end of 1937, both in absolute figures and per 100,000 of population. More than 3,600 licensees were reported by the

American Association of Personal Finance Companies, and over 3,300 were reported by state supervisory authorities; for the 27 states for which data were available receivables outstanding totaled $338,000,000. The greatest proportion of lending activity was in leading industrial and semi-industrial states, 9 of which accounted for more than three-fourths of receivables and for almost three-fourths of the loan offices.[12] Wide variations among states in average outstandings per loan office make the number of loan offices a less significant figure than the volume of outstandings in judging the relative concentration of personal finance lending; Pennsylvania with 502 licensees is first in number of loan offices, but ranks after New York and Ohio in outstandings.

The relative availability of personal finance facilities is most readily gauged by the density of loan offices per 100,000 of population, which varied in 1937 from 0.2 in Tennessee to 9.1 in Colorado. With three exceptions, Missouri, New Jersey and New York, all states reporting outstanding unpaid balances in excess of $10,000,000 had a loan office density of 4 or more per 100,000 of population. Available information indicates that facilities are almost non-existent where maximum legal rates of charge are relatively low,[13] as in Tennessee, and that where the small loan law empowers the state banking department to restrict the number of licensees in any particular community, as in New Jersey and New York, facilities are less numerous than in other states.

The comparative utilization of personal small loan facilities is clearly shown by outstandings per 100,000 of population. In general, states having a loan office density of 4 or above show outstandings per 100,000 of population of $300,000 or more. The ranking of states differs considerably, however, as between availability and utilization of facilities.

[12] In order of importance, according to receivables outstanding: New York, Ohio, Pennsylvania, Illinois, Michigan, Massachusetts, Indiana, New Jersey and Missouri.

[13] The effects of reductions in maximum legal rates are discussed in Chapter 7.

TABLE 1

GEOGRAPHIC DISTRIBUTION OF PERSONAL FINANCE COMPANIES IN 29 STATES, AND THEIR RECEIVABLES OUTSTANDING, DECEMBER 31, 1937[a]

State	*Licensees Reported*			*Outstandings*	
	By Amer. Assoc. of Personal Fin. Cos.[b]	By State Banking Depts.	Per 100,000 of Population[c]	Rep. by State Banking Depts. (in thousands)	Per 100,000 of Population[c]
Arizona	32	[d]	7.8	$ 1,276[e]	$311,980
Colorado	98	98	9.1	[d]	[d]
Connecticut	81	88	5.0	7,543	432,016
Florida	75	43	2.6	2,976	179,927
Georgia	7	8	.3	[d]	[d]
Illinois	354	358	4.5	35,054	443,722
Indiana	301	274	7.9	17,229	495,086
Iowa	136	117	4.6	7,675	299,688
Kentucky	32	32	1.1	3,069[f]	105,682
Louisiana	82	80	3.7	6,610	309,312
Maine	32	13	1.5	2,264	263,562
Maryland	129	112	6.6	9,773	579,656
Massachusetts	206	183	4.1	20,744	465,530
Michigan	192	191	4.0	22,411	465,248
Missouri	97	92	2.3	10,167	255,004
Nebraska	107	72	5.2	5,662	412,082
New Hampshire	9	[d]	1.8	105[g]	20,508
New Jersey	102	105	2.4	15,946	365,818
New York	271	265	2.0	53,067	407,393
Ohio	460	421	6.2	50,064[f]	740,482
Oregon	49	46	4.5	1,935	188,965
Pennsylvania	502	502	4.9	40,762	399,314
Rhode Island	67	61	8.9	4,705	685,860
Tennessee	6	[d]	.2	411[f]	14,251
Utah	25	18	3.5	1,369[h]	263,776
Vermont	10	9	2.3	446	116,449
Virginia	73	68	2.5	6,246	232,193
West Virginia	42	41[i]	2.2	4,552[i]	246,978
Wisconsin	42	43	1.5	5,801	198,054
TOTAL	3,619	3,340	3.6	337,862	384,833

[a] Of the 34 states that have enactments resembling the Uniform Small Loan Law we have included all for which data are readily available.

[b] American Association of Personal Finance Companies, *Roster of Personal Finance Companies in the United States* (1938). These data are as of July 1, 1938.

[c] Based on population estimates contained in *Annual Report, Comptroller of Currency* (1937). In deriving figures for number of licensees per 100,000 of population the number of licensees reported by state banking departments is used in the 26 cases where it is available; otherwise the *Roster* figure is used.

[d] Not available.

[e] As of July 1, 1937.

[f] After deduction of reserves for bad debts.

[g] Estimated.

[h] As of November 30, 1937.

[i] As of July 1, 1938.

Thus Ohio, with a loan office density of 6.2, utilized these facilities to the extent of $740,000 per 100,000 of population, but Arizona, with a loan office ratio of 7.8, showed outstandings of only $312,000 per 100,000. No simple explanation of these differences can be advanced. They can be accounted for in some measure by the relative concentration of population in urban industrial areas, and by the income and industrial composition of the population. High maximum legal rates appear to exercise some influence, permitting lenders to extend loans more freely among less reliable borrower groups. Another factor, of course, is the period of time during which legalized small lending has been practiced at rates attractive to lenders, a longer period enabling lenders to adjust their facilities more effectively to demand. One large chain lender has found that communities seemingly similar in all outward respects may contain widely varying numbers of borrowers, but it is not possible to say whether the reason lies in management, in varying local attitudes toward debt or in some other factor not readily perceivable.

LEGAL BASIS OF PERSONAL FINANCE COMPANY OPERATIONS

The personal finance business in its present form is an adaptation to specific legislative enactments. In most states until comparatively recently general statutory requirements as to interest charges precluded the lending of small sums at a profit, and this credit function was therefore fulfilled only in defiance of the law and at usurious rates. Sanction for higher legal charges was acquired only when the high-cost character of the small loan business became sufficiently widely recognized to compel permissive legislation. Underlying this legislation was a belief that statutory limitations on maximum interest rates must be relaxed in order to bring under regulation the lending of small sums to consumers, and to

encourage the flow of legitimate capital into such lending. In return for legal sanction of special interest charges lenders were required, for the protection of the borrower, to be licensed and to conform to certain standards of lending and collection in such matters as form of contract, maximum size of loan, repayment before maturity and penalties for infractions of the law.

The formulation of a practical model for uniform legislation in this field resulted largely from the work of two agencies, the Russell Sage Foundation and the National Federation of Remedial Loan Associations. Promotion of better standards in the lending of small sums has been a primary objective of the Russell Sage Foundation.[14] In 1907, the year of its establishment, this organization adopted a program actively sponsoring research in the small loan field and promoting the work of the remedial loan societies; later it cooperated closely with the National Federation in opposing unregulated lending and urging the passage of adequate small loan legislation. The National Federation was organized in 1909 to unify the work of the remedials, and Arthur H. Ham, a pioneer research worker in the small loan field for the Russell Sage Foundation, was active in both organizations. Within a few years many unlicensed lenders began to recognize the advantages that would accompany legal sanction of their operations, and in 1916 representatives of commercial lenders, remedial loan societies and the Russell Sage Foundation agreed upon a compromise plan for a Uniform Small Loan Law. This proposed law, in its original or in an amended form, has served as the model for most small loan legislation enacted since 1916.[15]

The sixth and latest draft of the model law was published

[14] See L. N. Robinson and Rolf Nugent, *Regulation of the Small Loan Business* (1935) pp. 85-87. We are indebted to this study for much of the historical material used here.

[15] For a more detailed history of the various drafts of the Uniform Small Loan Law see Robinson and Nugent, *op. cit.*, Chapter 6, and F. B. Hubachek, *Annotations on Small Loan Laws* (1938) pp. 4-6, 53-54.

in January 1935, and a seventh draft is in preparation (1939).[16] Drafts subsequent to the first have clarified various provisions and extended the scope of state supervisory powers. Recently the important changes have concerned rates; the principal modification introduced by the sixth draft was the substitution of a graduated rate, as described below, for the earlier fixed maximum rate of 3½ percent.[17] A summary of the chief provisions of the sixth draft follows:

Size of Loan. Loans are limited to a maximum of $300. This amount was chosen after preliminary studies of the market for small loans, and the limitation serves to restrict the lending activities of licensees.

Maximum Rate. The proposed maximum rate is 3½ percent per month on the unpaid balance up to $100, and 2½ percent per month on the remainder. No other charges or fees are permitted, and interest cannot be deducted in advance or compounded.[18] The borrower may repay in full before scheduled maturity, and may be charged only for the period during which he has the use of the money.

License. A license is required for each office. The supervisory authority, usually the state banking department, may license only persons of approved character and must consider community needs for additional loan office facilities. Applicants must have liquid assets of $25,000 per office, and must file a surety bond of $1000 or more to insure compliance with the law and protection of borrowers. No other business may be conducted in connection with the loan business without the consent of the licensing authority.

Supervision. To enable the supervisory authority to enforce the law, lenders must keep adequate records, file an annual report and permit examination at least once a year. The specified

[16] The seventh draft is not expected to differ substantially from the sixth.
[17] In proposing the initial maximum rate the Foundation recommended that it be reconsidered by each state after a reasonable period.
[18] The term "interest," when used for the charges of licensed lenders, includes all sums which the borrower may be required to pay; when employed by other lenders it may and frequently does include only a part of the charges paid by the borrower.

licensing official is authorized and empowered to make such general rules and regulations as may be necessary for the proper conduct of the business and enforcement of the law.

Regulations with Borrowers. Lenders must refrain from using misleading advertising. The borrower must receive a clear written statement of the terms of his contract, receipts for payments made, and the canceled note and security upon final payment. The lender must not accept from the borrower a note that is incompletely drawn, or a power of attorney or confession of judgment. Loans require the written consent of both husband and wife when made on the security of wage assignment or chattel mortgage on household furniture.

Penalties. Both licensees and unlicensed lenders are criminally liable for violation of the law; in such event their loans are void and their licenses, if any, suspended or revoked.

Exemptions. National and state banks, savings banks, trust companies, building and loan associations, credit unions and licensed pawnbrokers are exempted from the law.[19]

Small loan legislation of some kind had been adopted in 19 states and the District of Columbia by 1921, a number since increased to 39, including most of the leading industrial states. On December 1, 1939, the District of Columbia, Hawaii and 34 states had legislation resembling the model law, while in the remaining 5 states the small loan legislation deviated widely from the model. These two groups of states are classified in Table 2 according to the maximum rate of charge permitted. Of the total number, 5 states have a fixed maximum rate of 3½ percent per month on unpaid balance, and another 5 have a fixed maximum of 3 percent; others have various combinations of rates, and a few have fees. The 9 states which have no special laws covering small loans are: Idaho, Kansas, Montana, Nevada, North Dakota, Oklahoma, South Carolina, South Dakota and Washington.

[19] The intent of this provision is to exclude from the requirements of the law credit agencies that charge substantially lower rates or are regulated under other statutes.

TABLE 2

SMALL LOAN LEGISLATION AS OF DECEMBER 1, 1939, CLASSIFIED BY CONFORMITY TO UNIFORM SMALL LOAN LAW AND BY MAXIMUM CHARGES AUTHORIZED[1]

LAWS RESEMBLING THE UNIFORM SMALL LOAN LAW	MAXIMUM MONTHLY CHARGE ON UNPAID PRINCIPAL BALANCE
With flat maximum rate of charge	
Arizona, Florida, Louisiana, Maryland, Virginia	3½%
Minnesota, Ohio,[2] Oregon,[3] Rhode Island, Utah	3%
New Jersey	2½%
New Hampshire[4]	2%
Georgia[5]	1½%
District of Columbia[5]	1%
Arkansas[5, 6]	10% per year
Alabama[5]	8% per year
With graduated maximum rate of charge	
Kentucky, West Virginia	3½% on first $150; 2½% on remainder
Hawaii	3½% on first $100; 2½% on remainder
Illinois, Maine,[7] New York	3 % on first $150; 2½% on remainder
Michigan	3 % on first $100; 2½% on remainder
Iowa,[8] Massachusetts,[8, 9] Pennsylvania[10]	3 % on first $150; 2 % on remainder
Indiana[8, 11]	3 % on first $150; 1½% on remainder
Connecticut	3 % on first $100; 2 % on remainder
Missouri[12]	3% on loans of $100 and less; 2½% on loans of more than $100
Vermont	2½% on first $125; 2¼% on remainder
California[13]	2½% on first $100; 2 % on remainder
Wisconsin[8]	2½% on first $100; 2% on second $100; 1% on remainder
With other forms of charge	
Colorado, Nebraska, New Mexico	10% per year, plus other charges[14]
Tennessee	6% per year, plus expense fee[5, 15]

LAWS WHICH DO NOT RESEMBLE THE UNIFORM SMALL LOAN LAW

Delaware—Applies to loans up to $500. Rate is 6% per year, computed on original amount of loan and payable in advance, plus service charge of 2% of the loan.

Mississippi—10% per year plus fees that vary with size of loan. Company subject to $2000 privilege tax if rate of interest exceeds 20% per year.

North Carolina[16]—6% per year.

Texas—Loans subject to 10% per year maximum interest rate fixed by usury law and state constitution.

Wyoming[16]—25% per year.

[1] We are indebted to Frank B. Hubachek, counsel for the Household Finance Corporation, for help in revising this table and bringing it up to date. All rate quotations are maximum rates per month on unpaid balance, unless otherwise indicated.

As a possible alternative to classifying existing small loan legislation according to this standard Mr. Hubachek suggests a classification based upon the effectiveness of the legislation. Such a classification requires at least three subdivisions: effectiveness in providing capital to be lent; effectiveness in regulating the lawful lending business; and effectiveness in preventing high-rate lending. Mr. Hubachek has kindly supplied us with the following listing based on these criteria.

Laws in 27 states, and in Hawaii, resemble a draft of the Uniform Small Loan Law and meet the first test of effectiveness and in many cases the second and third: Arizona, California, Connecticut, Florida, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, New Jersey, New York, Ohio, Oregon, Pennsylvania, Rhode Island, Utah, Vermont, Virginia, West Virginia, Wisconsin.

Laws in 3 states—Colorado, Nebraska, New Mexico—differ materially in rate structure and other provisions from the Uniform Draft, but those in the first two have been effective in creating an adequate source of credit; the third has not been in effect long enough to permit judgment. None of these laws has succeeded in regulating legal lenders or in prohibiting illegal lending.

Laws in 4 states—Alabama, Arkansas, Georgia and Tennessee—and in the District of Columbia resemble the Uniform Draft but permit such a low maximum rate that they are totally ineffective.

Laws in 5 states—Delaware, Mississippi, North Carolina, Texas and Wyoming—are fragmentary and ineffective, yet they contain enough material to be included under small loan legislation.

[2] Fee of $1 on loans of $50 or less; on loans of more than $300 small loan rate permissible up to $300 and usury rate of 8 percent per year on balance.

[3] Minimum charge of $1 per month on secured loans.

[4] Fee of $1 on loans of $50 or less; $2 fee on loans over $50.

[5] Maximum rate alleged to be too low to enable licensed lenders to operate.

[6] Maximum interest rate of 10 percent per year is fixed by general usury law and state constitution.

[7] Minimum charge of 25 cents per month.

[8] Rate subject to administrative control.

[9] This is rate on chattel loans and comaker and endorsed paper. Other rates are: unsecured loans, 3 percent per month on first $150, 2½ percent on remainder; real estate loans, 2 percent per month; loans secured by certain bonds, stocks, bank books or insurance policies, 1 percent per month.

[10] Rate of 6 percent per year on balances outstanding after 18 months.

[11] Fee of 50 cents on certain loans.

[12] Note that rate is graduated according to amount of loan instead of according to unpaid balance.

[13] The maximum rate is a flat 2 percent per month when the security taken is insured for the benefit of the lender.

[14] Provisions regarding fees and charges are obscure.

[15] This fee (not to exceed 1 percent per month) is not an authorization but a limitation. Only expenses incurred may be charged.

[16] Licenses not required; regulation fragmentary.

ORGANIZATIONAL STRUCTURE OF PERSONAL FINANCE COMPANIES

The Uniform Small Loan Law does not require any particular type of structure for lending companies, and therefore loan offices are operated by individuals and partnerships as well as by corporations. The corporate form of organization was seldom used before the adoption of small loan legislation, but has since become increasingly important, particularly with the rise of chain lending and the great increase in the number of chain offices.

In the period that preceded the drafting of uniform legislation personal finance lending was carried on both by chain offices and by independent, single-office units, the former usually operating under distinctive names without revelation of common ownership. The beginning of licensed lending was marked by a substantial, though temporary, decline in chain organization; some chain lenders transferred their loan funds and equipment to states that had not adopted the model small loan law, while others, in becoming licensed lenders, consolidated their offices. Those operating single offices generally found it too inconvenient to shift their operations to unregulated states, and many became licensed lenders.

Although chain business was comparatively small in the first years of licensed lending, it grew rapidly after 1920, resulting in a significant concentration of personal finance business in the hands of a few chain companies.[20] This is shown by the record of the two largest companies: the Beneficial Industrial Loan Corporation owned 54 offices in 1922

[20] The concentration of the personal finance business in the hands of chain lenders is strikingly illustrated by Indiana data. In 1937 about 55 percent of the number of offices and 73 percent of total employed assets were controlled by chains; these figures, incidentally, reveal the larger average size of the chain office. The offices of local chains, more numerous than those of outside chains, controlled a proportionate share of the total assets—roughly 50 percent; outside chains, with only 8 percent of the offices, held as much as 21 percent of all personal finance assets. See Table 35, p. 119.

but rose to 303 in 1932 and 372 at the close of 1937; the Household Finance Corporation, with 35 offices in 1918 and 62 in 1927, had 151 by 1932 and 215 (not including 13 in Canada) at the close of 1937. According to a recent estimate chains held 66 percent of all outstandings of licensed personal finance companies at the close of 1932, at which time the two largest chains, Beneficial and Household, had 30 percent of all the business.[21] At the end of 1937 Beneficial had $72,000,000 of receivables and Household $61,000,000, the two companies together holding almost 40 percent of the $338,000,000 outstandings that were reported for the entire country.

The chief advantages enjoyed by chain organizations are: easier access to sources of capital; mobility of capital, in that funds may be transferred from office to office in accordance with the demand for loans; geographic diversification of risk, including the risk of reductions in legal rates of charge; economies of large-scale organization, permitting the development of more refined and more systematic accounting controls.

Despite the advantages of chain-office organization, many independently operated loan offices are reported to be profitable enterprises, particularly in communities where competing offices are few. Even where the market is shared with chain offices, they frequently compete effectively for business. Long-established relations with customers may account for the success of an independent office, community goodwill obviating the necessity for advertising expense. Again, an independent office operated by a skilful owner-manager, using part-time employees and unpretentious office quarters, may enjoy lower salary and overhead expense than the typical chain office. Advantages derived from convenient office location, a vital factor in attaining profitable loan volume, may

[21] Robinson and Nugent, *op. cit.*, p. 143. The above discussion of chain lending and single-office lending is based upon pp. 141-44 of Robinson and Nugent.

account for the success of a particular independent lender. Finally, an independent lender may successfully compete with a chain lender in the same community by having less exacting credit requirements; though he may thus incur higher losses he compensates them by charging higher rates.

The absorption of independent offices is one method by which chain organizations have expanded; establishment of new offices is another; enlargement of existing offices a third. Extension in the number of loan offices operated under one management has usually resulted from a combination of these methods, though one large chain declares that it expanded, as a matter of policy, primarily through the establishment of its own new offices.

SOURCES OF FUNDS

The financing of small loan companies has developed along familiar lines, with some modifications arising from the unique character of the business. In the earliest stage practically all capital consisted of the investment of individual entrepreneurs. Then the reinvestment of earnings played an important and even a dominant role. Next the marketing of both stocks and bonds, the latter carrying high coupon rates and sometimes profit-sharing provisions, was undertaken by the loan companies themselves. Finally, toward the end of the 1920's, the flotation of securities was accepted by established investment banking houses, and the facilities of the short-term money market began to be used increasingly by the leading companies.

The changing financial structure of personal finance companies during recent years, though partly ascribable to altered capital market conditions and to the sharp decline in interest rates, mirrors the changing status of this business within the national economy. These companies now have

comparatively easy access to the leading credit facilities of the financial world—commercial banks, the commercial paper market and the security markets—a development that signals their recognition as stable, established financial agencies. The change, particularly marked in the case of chain lenders, is apparent even in so short a period as 1929-37.

This is evident from Table 3, which shows the relative importance of invested and borrowed capital for two groups of chain lenders in 1929, 1933 and 1937, and for a third group in 1937. Total assets doubled during this period, but while the equity capital (common stock and surplus) of the two largest chains and of five other chains was more than half of total assets in 1929, it amounted to only about one-third in 1937. The latter ratio was paralleled very closely by thirteen other chains in the same year. Preferred stock also showed a tendency to decline in relative importance as a source of funds. Borrowed capital, on the other hand, increased both relatively and absolutely, for although the small amount of funded debt existing in 1929 had practically disappeared by 1937, the proportionate importance of short-term debt more than doubled for the five chains and more than tripled for the largest two.

Today chain companies not only obtain a large part of their short-term funds from commercial banks but, in addition, sell notes in the open market through commercial paper dealers. In Table 4 wherever notes payable have a peak level greater than the bank credit line the excess indicates funds obtained through the open market, although this by no means measures the total of funds so obtained.[22] One company, the Industrial Bankers' Securities Corporation, reported in 1937 a peak level of notes payable that was double the amount of its bank line.

[22] Even companies whose notes payable have peak levels below the bank lines may be selling some of their notes in the open market.

TABLE 3

SOURCES OF FUNDS OF SELECTED PERSONAL FINANCE CHAINS, 1929, 1933, 1937, IN PERCENT OF TOTAL ASSETS[a]

Source of Funds	*2 Largest Chains*			*5 Other Chains*			*13 Other Chains*
	1929	1933	1937	1929	1933	1937	1937
Total borrowings	*12.8*	*22.0*	*33.8*	*18.7*	*11.9*	*34.1*	*40.6*
Short-term debt	10.3	16.5	33.8	14.9	10.4	33.8	26.6
Funded debt	2.5	5.5	0.0	3.8	1.5	.3	14.0
Total capital stock and surplus	*77.5*	*72.6*	*59.5*	*79.4*	*85.5*	*54.6*	*42.2*
Preferred stock	22.6	24.1	20.0	25.7	16.2	20.9	9.0
Common stock and surplus	54.9	48.5	39.5	53.7[b]	69.3[b]	33.7[b]	33.2[b]
Total assets							
In thousands of dollars	$ 77,513	$ 89,079	$ 143,544	$ 15,688	$ 17,753	$ 32,854	$ 48,863
In percent of 1929	100.0	115.0	185.0	100.0	113.0	210.0	.....

[a] Based on data obtained from the National Credit Office, Inc. Percentages do not add up to 100; the difference represents capital and other reserves.

[b] Common stock and surplus ratio obtained by subtracting preferred stock from total capital stock and surplus. The common stock and surplus item may be overstated, and the preferred item understated, since in some cases preferred stock was not reported separately and hence was not included specifically as preferred stock.

TABLE 4

BANK LINES OF SELECTED PERSONAL FINANCE CHAINS, AND PEAK LEVEL AND LOW POINT OF NOTES PAYABLE, 1937[a]

Company	*Bank Line*	*Peak Level of Notes Payable*	*Low Point of Notes Payable*
American Investment Company of Illinois	$ 3,850,000	$ 3,563,960	$ 2,722,740
Beneficial Industrial Loan Corporation	35,000,000	29,800,000	17,400,000
Capital Loan and Savings Company	1,950,000	1,800,000	660,000
Commonwealth Loan Company	4,100,000	3,700,000	2,160,000
Family Loan Society	3,905,000	[b]	[b]
Household Finance Corporation	25,500,000	22,625,000	14,390,000
Ideal Financing Association	1,275,000	[b]	[b]
Industrial Bankers' Securities Corporation	600,000	1,200,000	800,000
Local Loan Company of Delaware	1,550,000	2,020,000	1,170,000
Monroe Loan Society	300,000	575,000	395,000
North American Finance Corporation	250,000	360,000	200,000
Railroad Employees Corporation	650,000	600,000	190,000

[a] Based on data obtained from the National Credit Office, Inc.
[b] Not available.

The terms on which funds are obtained from banks are less favorable for personal finance companies than for sales finance companies.[23] Reports from larger banks in principal centers indicate that at the end of 1938 maximum maturities on notes of both agencies ranged mainly from 3 to 6 months, but that the most frequent maturity required of sales finance companies was 6 months while for personal finance companies it was only 3 months; similarly, interest rates on loans to the two agencies showed much the same range, but the rates

[23] See the discussion of bank financing of personal finance companies in National Bureau of Economic Research (Financial Research Program), *Commercial Banks as Agencies of Consumer Instalment Credit*, by John M. Chapman and Associates (ms. 1939) Chapter 8.

most frequently charged were higher for personal finance companies than for sales finance companies. This difference in credit standing with banks appears paradoxical. According to one banker who has had long experience in lending to both types of consumer instalment credit agencies, there have been several sales finance companies that have fallen into financial difficulties of some kind over the last fifteen years, but it would be hard to name a single personal loan company that has encountered serious trouble.

For comparing the independent offices' sources of funds with those of chain offices data are available only for Indiana. Table 5, presenting this information, shows that in this state independent individuals and partnerships depend less on bor-

TABLE 5

SOURCES OF FUNDS OF 274 PERSONAL FINANCE LICENSEES IN INDIANA, DECEMBER 31, 1937, IN PERCENT OF TOTAL ASSETS[a]

Source of Funds	*Indiana Chains*	*Outside Chains*	*Independent Individuals*	*Partnerships*	*Affiliated Companies*	*Independent Corporations*	*All Companies*
Total debt	*37.9*	*34.8*	*24.2*	*3.5*	*67.0*	*43.6*	*39.4*
Short-term debt	30.3	27.9	20.0	...	22.9	35.7	28.4
Other current liabilities	6.4	6.9	4.2	3.5	37.7	6.1	8.3
Funded debt	1.2	...	...	...	6.4	1.8	2.7
Total capital stock and surplus	*59.4*	*60.6*	*73.6*	*96.3*	*30.8*	*53.3*	*56.9*
Common stock, surplus, proprietorship	40.8	35.4	73.6	96.3	10.7	39.2	34.8
Preferred stock	18.6	25.2	...	...	20.1	14.1	22.1
Number of reports	127	23	31	10	6	77	274

[a] Based on Indiana, Department of Financial Institutions, *Annual Report, July 1, 1937, to June 30, 1938*, pp. 139 and 142. Percentages do not add up to 100; the difference represents capital and other reserves.

rowed capital than do state chains, "outside" chains, affiliated companies and independent corporate lenders. In considering the Indiana figures it should be borne in mind, however, that parent companies extend loans to their subsidiaries, and that therefore what appears as borrowed capital on the balance sheets of subsidiaries may in fact represent funds that the parent concern has raised through the sale of its securities. To the extent that this occurs, the borrowed capital of outside chains and affiliated small loan companies stands in a lower ratio to the invested capital than is here indicated. Nevertheless, even the independent corporate lenders in Indiana use relatively more borrowed capital than do independent individuals and partnerships. One explanation is that since unincorporated lenders operate small offices, probably with a stable volume of business, short-term borrowing is unnecessary. Chains and incorporated independent lenders operating larger offices have a greater need for bank accommodation to finance their operations.

2

The Loan and Its Market

BORROWERS from personal finance companies represent all walks of life, but in three cases out of four they are wage-earners or clerical employees. They are drawn from the broad annual income range of $500 to $3500 but are concentrated at income levels between $1000 and $2500. On the average the loans they obtain slightly exceed one month's income; repayments, including charges, are spread over 5 to 20 months and require 5 to 10 percent of monthly income.

A clear understanding of the nature of the market for personal finance company loans demands a detailed examination of the characteristics of the loans that are made—their size, duration and security—of the economic characteristics of the borrowers—their incomes and occupations—and of the reasons for borrowing and the use made of the borrowed funds. While available information on such characteristics is limited, it is sufficiently extensive to show the distinguishing features of the business.

LOAN CHARACTERISTICS

Size of Loan

Personal finance lenders, operating under license, are restricted by law as to the sum that may be lent by any one licensee to any one borrower, the limit in most states being $300. Loans are made for all amounts up to this maximum, though as a result of varying economic factors different geographic areas show different tendencies in the predominant size of loans.

Table 6 shows the size distribution of loans made in 14 selected states during 1937 (for Maine, during 1936). In all these states except Indiana and New York loans of $50-100 were numerically the most important; loans of this size constituted, in the various states, from 25 to 32 percent of the total number of loans. On the whole, loans of $150-200 were the fewest, averaging in the neighborhood of 15 percent of all loans.

Among the important factors affecting the predominant size of loans in any state are the extent of industrialization and the height of the maximum legal rate of charge. As a rule agricultural states, where borrower incomes are generally lower than in industrial states, have a larger proportion of loans for $100 and less; a greater proportion of smaller loans is generally found in states that permit a charge of 3½ percent per month than in those allowing only 2½ percent, simply because the higher rate enables licensees to make a profit even on the smaller and more costly loans. But in addition to these general factors certain specific factors affect licensed lending in individual states. In Illinois about 22 percent of the loans are secured by wage assignment. Since this type of loan is usually smaller than loans otherwise secured, Illinois shows a high proportion of loans of $50 and less. In Indiana there are many lenders in agricultural county seats and small towns, where borrowers are likely to have lower cash incomes than urban residents of large cities, and the relatively high proportion of loans of $50 and less may be accounted for in part by this circumstance. Iowa also reports a comparatively large number of smaller loans. This might be expected in view of the agricultural nature of Iowa's economy, but there is another reason in the fact that this state passed its small loan law as early as 1921 and has many well-established independent lenders; in general, such lenders tend to cater to customers borrowing smaller sums than customers of chain lenders.

TABLE 6

PERCENTAGE DISTRIBUTION OF NUMBER OF LOANS MADE BY PERSONAL FINANCE COMPANIES IN 14 SELECTED STATES, 1937, BY SIZE OF LOAN[a]

State	$50 or Less	$50–100	$100–150	$150–200	$200–300	Total
Connecticut[b]	19.6	28.3	16.0	15.5	20.6	100.0
Illinois	24.0	27.7	14.7	13.0	20.6	100.0
Indiana	29.2	26.8	14.2	12.2	17.6	100.0
Iowa	21.9	30.0	17.4	13.5	17.2	100.0
Maine[c]	12.7	30.0	19.2	19.1	19.0	100.0
Maryland	25.8	31.0	13.2	12.0	18.0	100.0
Massachusetts[b]	15.7	27.2	17.7	16.2	23.2	100.0
Michigan	16.5	25.1	17.4	17.0	24.0	100.0
New York	13.5	26.0	16.2	16.1	28.2	100.0
Ohio	19.5	28.7	18.0	14.0	19.8	100.0
Pennsylvania	16.6	26.8	19.3	37.3		100.0
Rhode Island	22.2	28.7	16.5	14.9	17.7	100.0
Virginia	30.0	32.5	14.8	10.6	12.1	100.0
Wisconsin	12.0	27.0	18.5	21.1	21.4	100.0

[a] Based on annual reports of state banking departments or, for states in which such reports are not published, on accountants' reports prepared for state associations of personal finance companies from data filed with the state banking department. States selected according to availability of data. The period covered is the calendar year 1937 unless otherwise indicated. Each size level is exclusive of the lower figure and inclusive of the higher.
[b] Year ending September 30, 1937.
[c] Year ending December 31, 1936.

According to the best available evidence the average loan made by licensed lenders was gradually increasing in size before 1930. Estimates based upon state reports and reports of individual licensees indicate that the average loan, which had amounted to $55 in 1915, was approximately twice that figure by 1920 and reached $145 by 1930, but dropped to $130 in 1932.[1] Incompleteness in state supervisory reports makes it difficult to trace accurately, for any extended period, the average size of loans throughout the industry, but Table 7

[1] L. N. Robinson and Rolf Nugent, *Regulation of the Small Loan Business* (1935) p. 175.

shows average size in the period 1933-37 for all states on which data are available, and for 5 selected industrial states. The average loan for all reporting states rose gradually over this period to $147, approximating the level previously attained in 1930. The sustained differential between the average loan for all reporting states and for the 5 selected industrial states confirms the finding that in agricultural and semi-industrial states the average loan is usually smaller than in industrial states.

Table 7 also shows the average loan made in each year of the period 1933-37 by the three largest chain lenders. These chains together control more than one-sixth of all licensed loan offices and about 50 percent of the total volume of licensed lending. Two of these companies changed their loan policies during the period. The Household Finance Corporation formerly specialized in larger loans at rates below the legal maximum, but recently its loan policies have conformed more closely to the policies of other lenders, and its average loan has diminished. The decline in the average size of loan

TABLE 7

AVERAGE SIZE OF LOANS MADE BY PERSONAL FINANCE COMPANIES, 1933–37[a]

Year	*All Reporting States*[b]	*Five Selected Industrial States*[c]	*Beneficial Industrial Loan Corp.*	*Household Finance Corp.*	*American Investment Co. of Ill.*
1933	$126	$144	$144	$185	$162
1934	135	147	150	180	162
1935	135	146	153	167	148
1936	137	149	155	164	142
1937	147	153	153	169	148

[a] Based on annual reports of state banking departments and on data supplied by the three individual companies.
[b] The number of states represented is 13, except for 1934 and 1936, when it is 14; the states covered, however, are not always the same.
[c] Massachusetts, Michigan, New Jersey, New York, Pennsylvania.

made since 1933-34 by the American Investment Company of Illinois is due to the fact that in 1935 this company, as a matter of operating policy, began to make a larger number of $25 loans. The decline in the average size of its loans would possibly have been greater were it not for the fact that in 1934 the company extended its offices into New York City, where the average size of loans is considerably higher than in the midwest. The average loan of each of these three lenders is consistently larger, however, than that of all lenders combined, although in 1937 the difference between the average loan of all reporting lenders and that of the American Investment Company was negligible.

Duration of Loan

Most loans are now repayable over a period of 5 to 20 months, depending on the amount of the loan and on the credit of the borrower. The standard period for secured loans over $50 is 18 or 20 months, although practice varies among different lenders. At least one large company limits loans of $50 or less to 10 months, and loans on unsecured notes to 15 months. Some lenders do not set up a repayment schedule according to the size of loans, but determine the duration of each loan according to the particular needs of the borrower. In general, personal finance companies favor longer durations as a means of increasing profits, though not to the extent of imperiling their investment by subjecting it to the strain of possible disruptions in the flow of the borrower's current income.

Many present customers arrange new loans in order to pay off existing balances and to obtain additional sums, and therefore the actual life span of all loans,[2] according to the experience of one of the largest chains, ranges, on the average, from 8½ to 12 months. The total period of customer indebtedness typically exceeds the duration of the loan, rang-

[2] Considering each successive loan, as well as the original, as a separate loan.

ing from 26 to 29 months, or more than double the average loan period, according to data from the same chain.

Security for Loan

The security for loans made during 1937 (in a few cases, 1936) in 16 selected states is shown in Table 8. In most of these states about three-fourths or more of the loans were secured by a chattel mortgage. This is usually a blanket claim on house furnishings but frequently it is taken on only one item of the borrower's possessions. Automobiles, for example, provided the security for many loans, although the money may have been borrowed for purposes other than the purchase of the car. Many personal loans are now obtained to finance the purchase of a specific article, with a chattel mortgage on the article itself for collateral. While this type of loan is not new, some personal finance companies are now actively encouraging its use and thus impinging upon the sales finance market.

The use of the unsecured note by personal finance lenders is very widespread, amounting in a number of states to between 10 and 30 percent of all loans extended. The Household Finance Corporation, with 228 offices in 17 states and Canada, established in 1936 several experimental "honor" offices which were to make loans only on unsecured notes, and has gradually increased their number. This development is symptomatic of tendencies in personal finance.

Use of the endorsed and the comaker note, bearing the signature of one or more persons in addition to that of the borrower, varies considerably, ranging in different states from 3 to 23 percent of all loans. Loans on wage assignments, another type of security used by some personal finance lenders, are in most states an insignificant proportion of total loans,[3] but in at least one state, Illinois, 22 percent of all loans made in 1937 were thus secured.

[3] Wage assignments have so often made trouble for employers that it has become a not uncommon practice to dismiss employees when they are dis-

TABLE 8

PERCENTAGE DISTRIBUTION OF NUMBER OF LOANS MADE BY PERSONAL FINANCE COMPANIES IN 16 SELECTED STATES, 1937, BY TYPE OF SECURITY[a]

State	*Chattel Mortgages on*			*Unsecured Notes*	*Endorsed and Co-maker Notes*	*Wage Assignments*	*Real Estate*	*Other Security*	*Total*
	Household Goods	Automobiles	Other Goods						
Conn.[b]	...	...	...	18.3	23.4	.1	...	58.2[c]	100.0
Ill.		59.4		...	12.5	22.0	...	6.1	100.0
Ind.	55.0	18.3	9.4	14.1	2.8	...	...	.4	100.0
Iowa	55.1	20.9	3.0	9.6	4.2	5.4	...	1.8	100.0
Ky.[d]		67.0		20.2	12.5	.1	...	.2	100.0
Me.[e]		96.1		...	...	1.3	...	2.6	100.0
Md.	44.7	15.1	.2	30.9	2.7	6.2	...	.2	100.0
Mass.[b]	61.0	10.8	.5	17.6	9.6	.4	...	.1	100.0
Mich.	58.8	21.1	3.3	10.3	3.9	2.0	...	.6	100.0
Mo.	60.4	8.3	1.7	18.2	8.6	...	...	2.8	100.0
N. Y.	59.8	11.4	.6	14.2	8.1	5.4	...	.5	100.0
Ohio	49.8	23.1	4.6	13.7	7.6	.3	...	.9	100.0
Pa.	54.9	11.3	...	11.8	13.1	...	7.6	1.3	100.0
R. I.[e]	42.5	12.8	.1	26.5	17.0	.1	...	1.0	100.0
Va.	34.7	12.4	.1	29.8	15.1	...	...	7.9	100.0
Wisc.		84.7		...	8.2	.5	...	6.6	100.0

[a] Based on annual reports of state banking departments or, for states in which such reports are not published, on accountants' reports prepared for state associations of personal finance companies from data filed with the state banking department. States selected according to availability of data. The period covered is the calendar year 1937 unless otherwise indicated.

[b] Year ending September 30, 1937.

[c] Chattel mortgages cannot be taken in Connecticut, and therefore loans in this state are made principally on husband-and-wife notes.

[d] The percentages are based upon loans outstanding on December 31, 1936.

[e] Year ending December 31, 1936.

covered to have borrowed in this way. Since this gives the lender an opportunity to exploit the borrower's fear of losing his job, public opinion toward the wage assignment has been unfavorable, and in some states this form of security has been made illegal. In 1936 the Household Finance Corporation discontinued the practice of taking wage assignments, and on March 31, 1939, it was discontinued by the Beneficial Industrial Loan Corporation.

BORROWER CHARACTERISTICS

Income of Borrowers

Practically the entire credit market tapped by personal finance companies is composed of individuals, mainly urban residents, whose annual incomes are between $500 and $3500. Few applicants with annual incomes below $500 qualify as borrowers; few who receive annually more than $3500 seek accommodation. But the significance of this range is made clear by comparing it with the National Resources Committee estimates of income distribution in the United States. Over three-fourths of the non-farm income-receiving units of the country[4] were within this income range in 1935-36, and they received about three-fourths of the non-farm national income.[5] These facts suggest that the personal finance business caters to a very large section of the non-farm income-receiving population.

The income distribution of borrowers from the largest chain lender in the personal loan field is compared in Table 9 with the income distribution of the whole non-farm income-receiving population. The income bands of these two distributions are not exactly comparable; moreover, borrowers are grouped by individual income whereas income-receiving units are grouped by family income,[6] and therefore a larger proportion of individual borrowers than of family groups is to be expected in the lower income classes,[7] although this bias is probably offset in part by the difference in income

[4] Family and single-individual income receivers.

[5] Derived from figures of the National Resources Committee, *Consumer Incomes in the United States* (1938). We have excluded non-relief farm families from the total of income-receiving units because only an insignificant fraction of personal finance company borrowers come from this group. See Table 9, footnote e.

[6] Except in the case of sons and daughters who pay for their board and room but do not pool their entire income with that of others in the family.

[7] A borrower may belong to a family whose total income exceeds his own.

331.832
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4239

classification. The table indicates, however, that while 29 percent of all income-receiving units had annual incomes of $500-1000 in 1935-36, only 16.5 percent of borrowers were in that class. In each income band from $1000 to $3000 the proportion of borrowers was greater than that band's representation among all income-receiving units, but the top band (over $3000) comprised a very small number of borrowers compared to its number of income-receiving units.

TABLE 9

PERCENTAGE DISTRIBUTION OF BORROWERS FROM A PERSONAL FINANCE CHAIN, AND OF GENERAL POPULATION, 1935–36, BY INCOME LEVEL

Annual Income[a]	*Borrowers from Beneficial Industrial Loan Corporation*[b]	*Non-Farm Population*[c]	
		Income-Receiving Units[d]	Aggregate Income[e]
Under $500	1.3	16.9	3.3
500–1000	16.5	28.6	14.3
1000–1500	37.2	22.0	18.1
1500–2000	25.3	13.4	15.5
2000–2500	12.2	7.8	11.7
2500–3000	4.6	3.9	7.1
Over 3000	2.9	7.4	30.0
TOTAL	100.0	100.0	100.0

[a] For the distribution of Beneficial borrowers the income levels are $500 and under, $501–1000, etc.; for the distribution of general population they are under $500, $500–999, etc.

[b] Data supplied by the company, based on reported individual incomes.

[c] Adapted from National Resources Committee, *Consumer Incomes in the United States* (1938).

[d] Families and single individuals, including farm relief families. We have excluded non-relief farm families, numbering slightly over 6,000,000, from the total 39,458,300 income-receiving units.

[e] In computing the figures for non-farm income we have excluded the non-relief farm income from each income group. Table 10-B, p. 97, of the National Resources Committee study, gives a distribution of non-relief farm families by size of income. To obtain an estimate of non-relief farm income we have multiplied the number of families by the mid-point of the income intervals. The resultant figures were subtracted from those given on p. 6 of the National Resources Committee study to obtain non-farm income by income levels.

TABLE 10

PERCENTAGE DISTRIBUTION OF NUMBER AND VOLUME OF LOANS MADE BY 2 PERSONAL FINANCE CHAINS, AND AVERAGE SIZE OF LOANS, 1934–37, BY INCOME OF BORROWER[a]

Annual Income[b]	*Household Finance Corporation*			*American Investment Co. of Ill.*		
	Number of Loans	Volume of Loans	Average Loan	Number of Loans	Volume of Loans	Average Loan
$600 & under	.7	.4	$ 92	21.5	12.7	$ 87
600–1200	16.0	10.1	107			
1200–1800	33.9	30.1	150	41.3	37.4	134
1800–2400	26.8	30.0	189	27.3	35.2	191
2400–3000	11.6	14.3	209	6.5	9.3	209
Over 3000	11.0	15.1	232	3.4	5.4	236
TOTAL	100.0	100.0	168	100.0	100.0	148

[a] Based on data supplied by the two companies.
[b] Each level is exclusive of the lower figure and inclusive of the higher.

It is noteworthy that 91 percent of those who borrowed from the Beneficial Industrial Loan Corporation in 1935-36 had annual incomes between $500 and $2500, whereas this range included only 72 percent of the non-farm income-receiving units; the $1000-2000 range included 62.5 percent of the borrowers and only 35 percent of all income-receiving units.

The scant representation of borrowers from the lowest and highest income groups appears to be broadly typical of the industry as a whole, to judge by data for 1933-37 from two other chain companies, the Household Finance Corporation and the American Investment Company of Illinois.[8] Table 10 shows the income distribution of borrowers from these companies and the average size of loan in each income band. The income groups differ from those in Table 9, thus pre-

[8] The American Investment Company operates offices in 10 states through subsidiaries (General Public Loan Corporation and Public Loan Corporation). The Household Finance Corporation operates offices in 17 states.

cluding exact comparison, but the two tables show the same general pattern. Borrowers with annual incomes up to $1200 received 17 percent of all loans of the Household Finance Corporation and 21.5 percent of those of the American Investment Company. The former company extended 61 percent of its loans to borrowers with incomes from $1200 to $2400, and the latter company 69 percent. The proportion of borrowers with incomes above $2400 was slightly over one-fifth for the first chain as compared with one-tenth for the second, a contrast that undoubtedly reflects basic differences in lending policies as well as special advertising efforts on the part of the former company to attract borrowers from higher income levels.

The three chain companies cited in Tables 9 and 10 control slightly more than one-sixth of the licensed offices of the country and about half the total dollar volume in the licensed small loan field. The experience of this important group, while not conclusive, indicates that three-fourths of all loans made by personal finance companies are to borrowers with individual incomes between $1000 and $2500. About 15,000,000 income-receiving units in the country, or more than two-fifths of the total, excluding non-relief farm units, have incomes within this range. It is probable that roughly one out of seven of this group obtained credit accommodation from personal loan companies in 1936.[9] Furthermore, interpolation reveals that about half of all borrowers fell in the $1000-1800 income band, a proportion much above this band's share of all income-receiving units, which is only about 33 percent.

In Table 10 the distribution of loan volume, as distinct from number of loans, among different income groups re-

[9] If three-fourths of all loans made by personal finance companies were to borrowers with incomes between $1000 and $2500, and there were approximately 3,000,000 borrowers at the end of 1936, then around 2,250,000 borrowers fell within this income range. This is roughly one out of seven of the 15,000,000 non-farm income-receiving units in this income range.

veals that the dollar borrowings of customers with annual incomes under $1200 are considerably less than proportionate to the number of such borrowers; those of customers with $1200-1800 incomes are slightly less than proportionate; and the borrowings of customers with incomes above $1800 are substantially more than proportionate. This can only reflect a direct variation between loan size and income level, thus raising the question of the amount that borrowers in these various income groups typically obtain on personal finance company loans.

In regard to the two chain lenders represented in Table 10, customers in the income band showing the greatest concentration of borrowers—$1200-1800, or $100-150 monthly—received an average loan of $150 from the Household Finance Corporation and $134 from the American Investment Company. In the $150-200 monthly income band the average loan was about the same for both lenders, $189 and $191 respectively. In general, the table indicates that customers with monthly incomes below $200 obtain loans approximately equal to, or greater than, one month's income, while those receiving $200 or more obtain loans somewhat smaller than one month's income.

The size of the loan does not depend solely on the desires of the borrower; it depends also on what the lender is willing as a matter of policy to advance and this, in turn, depends on the lender's views regarding a safe relation between borrower income and amount borrowed. On this question there is no standard practice, but the most common rule is that the loan should not exceed one month's income. As noted above, customers with monthly incomes in excess of $200 do not usually borrow as much as one month's income, perhaps because they are more likely to have savings in various forms to meet family or individual emergencies and special financial needs. Also, as a group, they have readier access

to alternative credit sources than do persons in lower income brackets.

Occupations of Borrowers

The distribution of all non-relief families in the period 1935-36, presented in Table 11, confirms the well-known relationship that exists between income and occupation. Three out of four borrowers, it will be recalled, receive annual incomes between $1000 and $2500, and according to Table 11 this range includes 51 percent of all non-relief families in the United States. In almost half of the non-relief families within this income range the principal breadwinner is classified as a wage-earner. This is in striking contrast to families whose annual incomes are over $3500; in this group less than one-tenth of the principal breadwinners are wage-earners.

TABLE 11

PERCENTAGE DISTRIBUTION OF ALL NON-RELIEF FAMILIES, 1935–36, BY OCCUPATION AND INCOME LEVEL[a]

Annual Income[b]	*Wage-Earning*	*Farming*	*Clerical*	*Business*		*Professional*		*Total*
				Salaried	Independent	Salaried	Independent	
$500 and under	4.1	4.5	.3	°	.8	.1	°	9.8
500–1000	11.0	8.9	2.1	.2	2.0	.3	.1	24.6
1000–1500	11.3	5.8	3.6	.5	2.2	.7	.1	24.2
1500–2000	6.8	3.0	3.5	.9	1.7	.8	.1	16.8
2000–2500	3.1	1.4	2.5	.8	1.1	.7	.1	9.7
2500–3000	1.5	.7	1.4	.5	.6	.4	.2	5.3
3000–3500	.7	.4	.8	.4	.4	.3	.1	3.1
Over 3500	.6	.8	1.0	1.3	1.3	.8	.7	6.5
TOTAL	39.1	25.5	15.2	4.6	10.1	4.1	1.4	100.0

[a] Adapted from National Resources Committee, *Consumer Incomes in the United States* (1938) p. 97.

[b] Each level is inclusive of the lower figure and exclusive of the higher.

° Less than 0.05 percent.

TABLE 12

PERCENTAGE DISTRIBUTION OF LOANS MADE BY 3 PERSONAL FINANCE CHAINS, 1934–37, BY OCCUPATION OF BORROWER[a]

Occupational Group	*Beneficial Industrial Loan Corp.*	*Household Finance Corp.*	*American Investment Co. of Ill.*
Wage-earning			
Unskilled	59.1	5.2	9.5
Skilled and semi-skilled		39.4	50.5
Clerical and commercial			
Office and other non-manual workers, including government employees	16.5	18.6	25.1
Commercial and selling	6.7	6.0	4.8
Business			
Salaried employees	5.3	10.2	6.1
Proprietors	4.3	9.9	
Professional			
Schoolteachers	2.7	6.9	1.8
Others	1.4	2.6	1.2
Farming	2.3	[b]	1.0
Persons with independent incomes	1.7	1.2	[c]
TOTAL	100.0	100.0	100.0

[a] Based on data supplied by the three companies.
[b] Included in business and wage-earning groups.
[c] Loans to persons with independent incomes are distributed among the other occupational groups.

Borrowers from personal finance lenders earn their living in a great variety of occupations, as is evident from Table 12, which shows the occupational distribution of customers of the three largest chain lenders during the period 1934-37. The occupations represented in original tabulations furnished by these lenders have been reclassified, when necessary, under five main headings, and arranged in the order of their numerical importance as borrowers: first, the wage-earning group; second, clerical and commercial; third, busi-

ness; fourth, professional; and fifth, farming. Variation in the geographic and economic scope of the companies' activities results in certain differences in the occupational distribution of their borrowers, but the story told by the three sets of figures is essentially the same.

For two companies about three-fifths of the borrowers, for the other over two-fifths, are wage-earners in unskilled, semi-skilled and skilled occupations. Skilled and semi-skilled occupations have a larger representation than the unskilled group, presumably because their higher incomes give them a superior credit status.

Borrowers from clerical and commercial occupations are second in importance, comprising about one-fourth of the customers of two lenders and three-tenths of the customers of the third. For one lender the salaried and independent business groups provide 10 percent of the borrowers, for another, 20 percent, and for the third only 6 percent, while the professional group supplies about 4, 10 and 3 percent respectively. Farming is a very minor occupational source of demand. There are, finally, a few borrowers with independent incomes.

It is important to note that most personal finance borrowers come from occupational groups other than farming. Being entrepreneurs as well as consumers, farmers tend to intermix their personal and family financing with their business financing, and to use primarily the credit sources—such as commercial banks, mortgage and other farm credit agencies—that are available to them as entrepreneurs. Moreover, seasonal variations in the flow of their cash income make it inconvenient for them to obligate themselves for loans that call for regular monthly amortization. Hence for an indication of how the occupational distribution of personal finance borrowers compares with that of the general population the data on borrowers should be compared not with those on

all non-relief families but with the data on such families engaged in non-farm pursuits.

Such a comparison, figures for which are presented in Table 13 for 1935-36, shows that the wage-earner and clerical

TABLE 13

PERCENTAGE DISTRIBUTION OF LOANS MADE TO EMPLOYED BORROWERS BY 3 PERSONAL FINANCE CHAINS, AND OF NON-RELIEF FAMILIES IN THE UNITED STATES, 1935–36, BY OCCUPATION[a]

Occupational Group	*Employed Borrowers*			*Non-Relief Families*	
	Beneficial Industrial Loan Corp.	Household Finance Corp.	American Investment Co. of Ill.	Non-Farm	Total
Wage-earning[b]	59.0	44.5	57.2	52.7	39.3
Clerical[c]	24.7	25.3	30.1	20.3	15.1
Business	9.8	20.3	8.5	19.5	14.5
Professional	4.2	9.9	3.1	7.5	5.5
Farming	2.3	[d]	1.1	...	25.6
TOTAL	100.0	100.0	100.0	100.0	100.0

[a] Data on borrowers supplied by the three companies; data on non-relief families based on National Resources Committee, *Consumer Incomes in the United States* (1938) p. 97.
[b] Skilled, semi-skilled and unskilled manual workers.
[c] Office workers, commercial and sales personnel, and other non-manual workers, including government employees.
[d] Included in business and wage-earning groups.

occupations provided 84 percent, 70 percent and 87 percent of the borrowers from these three companies, and were the income source of 73 percent of all non-farm, non-relief families in the country. It is interesting to note that among the Household Finance Corporation borrowers, wage-earners constituted a proportion about one-fourth less than their proportion for the other two chains, and that the proportion of clerical borrowers was about one-fifth higher in the American Investment total than it was in the totals of the other two

companies. The business and professional occupations, sources of livelihood for 27 percent of the non-farm, non-relief families, gave rise to 14, 30 and 12 percent of the personal finance loans extended by the three companies, the Household Finance Corporation extending more than twice as high a proportion of its loans to each of these two groups as did either of the other companies. On the assumption that an occupational distribution of all personal finance company borrowers would conform to the pattern for these three largest chain companies, we may infer that the major source of demand for personal finance credit is urban industrial groups.

Reasons for Borrowing and Uses of Funds

Basically all borrowing is necessitated by a maladjustment, temporary or otherwise, between income and expenditure, by needs or desires that the borrower is unable or unwilling to satisfy at the moment from current income or savings. Any classification of personal finance company loans according to reasons for borrowing and the use made of the funds must be based on borrower statements made at the time of loan application, and is necessarily somewhat arbitrary. That most borrowers from personal finance companies are without substantial savings may be inferred from the distribution of their incomes presented above, and those who possess savings may prefer the discipline of a regular repayment program. Applicants lacking reserve resources may require cash for one of several needs, so that if funds were not borrowed for one use they would probably be borrowed for another. Hence a classification of loans according to the use made of funds serves mainly to indicate various uses for which loans are needed. Nevertheless, such a classification is not altogether without meaning, particularly when it represents the average of several years' experience, for it suggests the dominant types of emergency situations that are immediately responsible for borrowers' demands.

A classification of the "reasons for borrowing," as distinct from "uses of funds," that is, a classification of the circumstances that make it impossible for the borrower to meet an expense out of reserves or current income, is presented in Table 14, based on the experience of the Household Finance

TABLE 14

PERCENTAGE DISTRIBUTION OF LOANS MADE BY A PERSONAL FINANCE CHAIN, 1933–37, BY REASON FOR BORROWING[a]

Reason for Borrowing	*Loans*
Loss of income	
Lack of employment	3.4
Wage-earner sick or injured	1.2
Other loss of income	1.7
Unusual large expenditure	47.7
Miscellaneous	
Failure to save for periodic expenses (taxes, interest, insurance, clothing, coal, etc.)	36.2
Failure to keep current expenses within normal income	5.8
Not reported	1.3
New contracts to readjust monthly payments	2.7
TOTAL	100.0

[a] Based on data supplied by the Household Finance Corporation.

Corporation during 1933-37. Practically half of all loans were sought to meet an "unusual large expenditure"; more than a third were needed because the borrower had failed to provide for periodic expenses such as taxes, interest, insurance, clothing and so on. In about 6 percent of the cases current expenditures had exceeded a normal budget allowance; another 6 percent were caused not by a rise in expenses but by a fall in income, as a result of illness, injury or unemployment of the breadwinner. Finally, about 3 percent of borrowers merely replaced old contracts with new ones, so that their payments could be spread over a greater number of months than provided in original contracts. As has been

TABLE 15

PERCENTAGE DISTRIBUTION OF LOANS MADE BY 3 PERSONAL FINANCE CHAINS, 1934–37, BY INTENDED USE OF FUNDS[a]

Use of Funds	*Beneficial Industrial Loan Corp.*	*Household Finance Corp.*	*American Investment Co. of Ill.*
Non-durable consumer goods	*14.2*	*20.6*	*19.1*
Food	14.2	1.7	2.9[b]
Clothing		9.1	13.1
Rent		3.3	[b]
Fuel		6.5	3.1
Durable consumer goods	*18.4*	*14.7*	*10.0*
Furniture	4.3	5.7	6.2
Automobiles	10.5	4.4	[c]
Repairs	3.6	4.6	3.8
Medical and funeral costs	*10.5*	*18.3*	*16.9*
Medical, hospital and dental	9.9	17.5	16.2
Funeral expense	.6	.8	.7
Business purposes	*6.6*	*6.2*	*5.3*
Business capital	5.1	6.2	5.3
Investment	1.5		
Debt	*39.3*	*24.2*	*35.1*
Consolidation of existing obligations	30.5	10.3	28.0
Taxes	4.8	6.2	3.7
Mortgage principal and interest	2.0	4.6	1.3
Insurance premiums	2.0	3.1	2.1
Cultural and recreational purposes	*4.8*	*7.4*	*7.9*
Education	1.2	2.1	1.5
Travel and vacation	3.6	5.3	6.4
Miscellaneous	*6.2*	*8.6*	*5.7*
Assistance to relatives	2.3	4.3	4.4
Moving expenses	1.6	2.0	1.3
Other	2.3	2.3[d]	...
TOTAL	100.0	100.0	100.0

[a] Based on data supplied by the three companies.
[b] Loans for food and for rent are grouped together.
[c] No data. Few loans to finance payments for automobiles are made by this company; those that are made are classified principally under "Consolidation of existing obligations."
[d] Includes loans that are incurred in order to retire borrowings from competing lending concerns.

suggested, this distribution must not be interpreted too literally; a careful examination of case histories of applicants might reveal that many borrowings classified, for example, as resulting from failure to save for periodic expenses, or from failure to keep current expenses within current income, could be accounted for by an unusually large expenditure in the not too distant past.

A more informative classification is one based on the immediate use to which borrowed funds are stated to be destined. Table 15 provides three sample distributions of this type, based on the loan experience of the Beneficial Industrial Loan Corporation, the Household Finance Corporation and the American Investment Company of Illinois during 1934-37. The approximate similarity of the distributions suggests that the stated reasons for borrowing reflect in considerable measure the actual occasions and emergencies that give rise to the demand for personal finance company loans.

From these data it may be concluded that more than one-sixth of all loans are applied to the basic living expenses which are represented by non-durable consumer goods. Almost another sixth are used for medical needs and funeral expenses. Apart from the "consolidation of existing obligations," medical expenses are mentioned more frequently than any other single item as the intended use of borrowed funds.[10] A special classification of all loans made in the first quarter of 1936 by the Detroit offices of the Household Finance Corporation showed that loans for medical expenses were most numerous in all annual income groups except that exceeding $3000, in which the number of loans for business purposes slightly exceeded those for medical purposes. Loans to borrowers with incomes of $1200 or less were

[10] Except in the data for the Beneficial Industrial Loan Corporation, which show a slightly higher proportion of loans for automobiles than for medical expenses in this period. Data for the Household Finance Corporation show an even higher proportion of loans for medical expenses than for the consolidation of existing debt.

more predominantly used for basic living expenses than were those to borrowers with incomes over $1200, and a larger proportion of loans to manual workers were used for this purpose than were loans to the clerical and professional groups. Similarly, the smaller the loan the more likely was it to be used to defray basic living expenses.

In Table 15 the consolidation of existing obligations accounts for by far the largest proportion of loans in the totals of two of the companies. This item, however, is particularly ambiguous, and there is no standard practice as to what it should comprise. Some companies, for example, classify under this or similar headings all loans used to pay off retail charge accounts, regardless of the purpose for which the charge account debt was incurred, and regardless of whether the outlays were made before or after the loan was negotiated. Loans that are used partly to retire unpaid balances of existing loans, and partly to advance new funds, are also very inadequately classified under this category. But as a matter of fact, the distinction between refinancing existing debts and financing new expenditures is often without much foundation, for it is likely that many who borrow to consolidate old debts have incurred those debts only because of confidence in their ability to care for them by means of a loan from a personal finance company. Thus the effect of licensed lending upon current consumer expenditure cannot be judged merely by the proportion of loans made for purchases that are ostensibly new. All that can be said is that refinancing is the purpose of a significant proportion of total loans, the proportion ranging from 25 to perhaps 75 percent, according to the classifications used. Probably 25 or 30 percent of all loans are made for refunding miscellaneous debts, but many other loans are obtained to repay specific debts already incurred, and this group cuts across the entire classification of loans according to intended use.

It is of some interest that about 6 percent of all loans

made by personal finance companies are specifically for business purposes, indicating that no hard and fast line is drawn between producer and consumer credit in personal finance lending. The proportion of loans extended for production purposes is of small quantitative importance, but the figure cited may be an understatement; it is likely, for example, that many who finance the purchase of a car through a cash-lending agency will use the car for business as well as pleasure.

3

Operating Methods and Collection Experience

CONTROL of credit risk in the personal finance business presents special aspects intrinsic to the nature of such lending, geared in each case, as it must be, to the extension and administration of hundreds and even thousands of small loans. Under these conditions, credit granting must proceed speedily, accurately and at low cost, necessitating procedures and standards that are highly routinized yet acutely sensitive to dubious risks. The loss from slow collection or ultimate charge-off on a single small loan is not an imposing sum, but successful operation requires that better than ninety-five out of every hundred loans consistently pay out, and that delinquency, a vital element of collection cost, be held within tolerable limits. Not only must credit granting proceed swiftly and effectively, but business continuity requires that a steady flow of loan demand be maintained. Since profitability of operations tends to increase (up to a certain point) with loan volume, every loan office must continuously strive to increase the number of customers it serves.

METHODS OF OBTAINING BUSINESS

Students of credit retailing have frequently pointed out that in the personal small loan business the longer a lender can keep his money in the hands of the same group of borrowers the larger his profits will be. When there are no special credit-granting and investigating fees, customer turnover increases costs of investigation and adds nothing to revenue.

On the other hand, lengthening the period of customer indebtedness, either by longer contracts or by successive loans to the same borrowers, increases risk. Extended repayments weaken the morale of borrowers, and the favorable situation with respect to income and stability of home conditions that obtained at the time of the original investigation may become increasingly uncertain as time passes. In seeking maximum revenue, lenders necessarily strive to maintain a loan portfolio in which these cost and risk factors are counterbalanced.

With these considerations in mind, lenders actively solicit loan applications from former customers, and draw about one-tenth of their applicants from this group. Such applications are readily granted if past loans have been repaid; three-fourths or more of them, according to the experience of two chain companies, are accepted. Also, present borrowers are actively encouraged to apply for additional sums; such requests typically amount to more than half of all loan applications, and they are granted, when payments on outstanding balances are up to date, in more than nine out of ten cases. The lender cultivates these borrower groups because a given volume of loans to them costs less than the same volume to new borrowers.

The importance of past and present borrower groups as a source of loan demand does not, of course, free lenders from the necessity of finding new customers to sustain and swell their loan volume. Nearly half of all loan applications come from new customers, though only about a third to a half of their applications are granted. Office location and advertising are important factors in attracting new borrowers. At one time loan company offices were on the second floor and had painted windows, and the result was the encouragement of furtive borrowing. The business is now conducted with entire openness, though loan companies still retain private consultation rooms where prospective borrowers may

discuss their circumstances with the manager without fear of being overheard by clerks or other applicants. In former years the surreptitious character of the business made it impossible to develop an aggressive advertising program,[1] but after operations were legalized and the personal finance company became a recognized financial institution, advertising methods came to duplicate those used in any other business. Newspapers, periodicals, radio, mail circulars, theater and billboard advertising, bus, train and streetcar posters, have all been utilized to communicate with potential borrowers, and have helped to establish the present market for small loans.

Other promotional devices to attract new customers include the granting of special rates for preferred risks, and the use of unsecured notes. To attract schoolteacher borrowers, for example, some companies offer them lower rates than those offered borrowers in other occupations, the security of schoolteacher income providing the greater safety which justifies the lower charge. Lower rates are sometimes offered on larger loans in order to attract borrowers from the higher income brackets, for there is a direct correlation between income of borrower and size of loan. One large chain company, as mentioned in Chapter 2, has established over the past few years a number of offices making only unsecured loans, an appeal to customers who do not care to pledge household chattels as loan security.

Finally, in order to cultivate community goodwill, lenders consider it effective promotion to furnish a budget service to their customers. Loan men are taught how to prepare budgets for families of given size, income and tastes. Sometimes loans are granted only on condition that the borrower adhere to the budget worked out for him, and occasionally the borrower receives his loan not in cash but in one or more checks payable to creditors. Not infrequently the loan company,

[1] Newspaper advertising was used to some extent even in the loan-shark era, however; see L. N. Robinson and Rolf Nugent, *Regulation of the Small Loan Business* (1935) pp. 37-42.

with the borrower's permission, approaches creditors in an effort to persuade them to accept partial payment in full settlement of their claims. At least one chain company has urged borrowers, upon completion of their payments, to continue setting aside each month, as savings, an amount equal to their monthly instalments. In some cases loan companies have acted as employment agencies. It has become customary in the business for lenders to view themselves as consultants in family finance, with the object of fostering community goodwill and a wider familiarity with their credit facilities.

Although most small loan borrowers intend to meet their obligations, they are as a group particularly subject to unexpected loss of employment, and when this occurs they may find it impossible to repay in accordance with the terms of the contract. Lenders therefore find it highly important to pursue a policy of diversification, in order to limit the number of borrowers likely to be affected by the shutdown of a particular factory or the decline of a particular industry.

The two principal bases of diversification are occupation and geographic location. They are not, of course, mutually exclusive: the need to spread operations over many communities results partly from the dependence of certain localities on one or two industries—the concentration of automobile manufacturing in Detroit, for example—and partly from the circumstance that an industry may be flourishing in one part of the country and stagnant in another.

The necessity for occupational and geographic diversification as a means of spreading risk has accelerated the chain lenders' extensive market expansion in recent years. The Beneficial Industrial Loan Corporation, in citing the extent of its operations, has stated that "the wide geographical and industrial diversification thus obtained, in addition to the essential character of the business, minimizes adverse effects of business depressions upon the operations and profits of the

Company."[2] The stability of the earnings of large chain lenders during the depression of 1929-33 emphasizes the wisdom of widely distributing risks.[3] Independent offices and very small chain lenders are able to achieve some diversification, but they lack the advantages of a wide territorial distribution of business.

OFFICE ORGANIZATION AND PROCEDURE

A licensed office usually requires at least three people to conduct all essential activities: a manager, an "outside" man and a clerk. The manager interviews applicants, decides on all applications and is in charge of the office. The outside man investigates applicants, undertakes to collect long-delinquent accounts and institutes a search for borrowers who have disappeared. The clerk receives and records payments, and usually does all the bookkeeping as well as the secretarial work of the office. It is estimated that a staff of three can administer effectively about 750 loans at a time, representing outstandings of $70,000 to $100,000. Independent licensed offices may operate on the basis of a substantially lower loan balance, but if a chain office is not able to maintain an average of more than $50,000 outstandings, with good prospects for expansion, the staff will probably be reduced or the office transferred to another community where the time of employees can be utilized more fully.[4] Larger offices require an assistant manager and an additional number of outside men and clerks, the total number depending upon the volume of business and the quality of personnel. Chain offices are controlled through a system of supervisors, each in charge of six to twelve offices that he visits at least once a month.[5]

The rise of chain lending has necessitated the development

[2] Beneficial Industrial Loan Corporation, *Annual Report for 1929.*
[3] For the two largest chain lenders the ratios of net income to total assets were 11.2 and 9.3 in 1929. In 1933 the ratio was 8.9 for both companies.
[4] Robinson and Nugent, *op. cit.*, pp. 203-04.
[5] *Ibid.*, p. 205.

of centralized methods of control, the training of a staff along uniform lines being especially imperative. To this end the larger chains have found it advantageous to establish courses of instruction for employees, the best known of which is the two-year correspondence course of the Industrial Lenders Technical Institute, operated by the Beneficial Industrial Loan Corporation. For several years the company made the course available not merely to its employees, who were required to take it, but to anyone connected with the industry, and reports state that at one time 1,200 outside persons were enrolled. The Household Finance Corporation also has an extensive training course for its own employees, developed with the aid of Northwestern University; it includes manuals, written tests and lectures illustrated with sound-slide pictures.

The applicant for a cash loan is interviewed privately by the manager of the loan office or one of his assistants, and answers standardized questions for an application form which the manager usually fills out. He states the purpose of borrowing, gives an account of his financial condition and makes a tentative estimate of his ability to repay within a stated period. During this confidential interview the manager must determine whether the applicant appears to be a good credit risk; in some cases the applicant's statements or manner call for an immediate refusal of the loan.

All applications not patently ineligible for loan consideration are investigated. The stated facts are checked by the outside man, who visits the home of the applicant, estimates his financial responsibility and reviews the household budget, paying particular attention to the amount of debt to which the family is already committed. The investigator also evaluates those intangible factors that indicate the extent to which the home is stable and well managed. Unless the applicant can show a file of receipted bills his financial responsibility is investigated among the tradespeople in his neighborhood, the investigator sometimes posing as the representative of a

mythical credit bureau or life insurance company. This practice, though considered justified in some cases, is generally frowned upon by lenders as unethical, since the private or confidential character of the borrowing transaction is strongly emphasized in advertising. The lender may consult a credit exchange, retail credit bureau, legal files of debt judgments or competing lenders. As a rule, small loan companies have been opposed to joining established retail credit bureaus, preferring to organize their own[6] because of the emphasis they place on a confidential relationship with borrowers. Sometimes such bureaus in different cities cooperate in order to reduce duplicate borrowing and the evasion of obligations by customers.

Investigation of former and present borrower applicants is facilitated by offices files, which record previous investigations and past payment performance. As has already been stressed, such borrowers are much more successful than new applicants in obtaining credit. Table 16, presenting the records of two chain lenders over a several-year period, shows that one company granted loans to only one-third of all new applicants, the other company to somewhat more than one-half. Former borrowers fared much better, 78 and 87 percent of them having their applications approved by the two companies respectively. While the general trend of these proportions is significant, no special importance should be attached to the differences between the two companies, because they may vary in their loan policies and also may follow different principles in classifying their loan applications. Both companies approved about 95 percent of present borrowers' applications.

Supplementary information from the Household Finance Corporation indicates that in this period 14 percent of all applicants were refused immediately, without investigation, and that such refusals were approximately 40 percent of all

[6] For a list of these bureaus see American Association of Personal Finance Companies, *Roster of Personal Finance Companies* (1938).

TABLE 16

NUMBER OF APPLICATIONS RECEIVED AND OF LOANS GRANTED BY 2 PERSONAL FINANCE CHAINS, 1933–37, BY STATUS OF CUSTOMER[a]

Status of Customer	Applications		Loans		Loans in Percent of Applications	
	Household Finance Corp.	Amer. Invest. Co. of Ill.	Household Finance Corp.	Amer. Invest. Co. of Ill.	Household Finance Corp.	Amer. Invest. Co. of Ill.
New	1,634,710	149,650	543,291	85,664	33.2	57.2
Former	389,363	24,921	303,373	21,740	77.9	87.2
Present	1,508,621	127,921	1,421,506	121,874	94.2	95.3
TOTAL	3,532,694	302,492	2,268,170	229,278	64.2	75.9

[a] Based on data supplied by the two companies. Applicants not receiving loans include those who decided not to borrow at all, or to borrow elsewhere.

rejections. Outright rejections were relatively fewer in the depression period of 1932-34 than in subsequent years.

COLLECTION PROCEDURE AND EXPERIENCE

Borrowers are required to mail or bring payments to the loan office each month, and collection procedure is set in motion if payments are not made when due. A routine has been established whereby a series of form letters is mailed to delinquent borrowers; if the first few letters fail to bring results an investigator is sent to ascertain the cause of the delinquency and to bring pressure to bear for payment.[7] The collection problem in personal finance starts with delinquency and ends with refinancing, foreclosure or final charge-off.

Delinquency[8]

Much so-called delinquency is merely technical, as in the case of borrowers who on the last day of the month mail checks

[7] See Robinson and Nugent, *op. cit.*, pp. 211-12.
[8] See also "Charge-off of Bad Debts," pp. 78 ff.

TABLE 17

DELINQUENCY PERCENTAGES ON SMALL LOAN ACCOUNTS DELINQUENT ONE MONTH OR MORE ON BOTH PRINCIPAL AND CHARGES IN SELECTED STATES, 1937[a]

State	*One Month*	*Two Months*	*Three Months or More*	*Total*
Connecticut[b]	4.35	1.16	7.63	13.14
Florida[c]	4.08	1.20	4.09	9.37
Illinois	5.90	1.45	2.81	10.16
Indiana	6.59	1.89	3.49	11.97
Iowa	6.98	1.66	2.21	10.85
Kentucky	7.49	1.86	3.18	12.53
Maine[c]	3.00	.74	1.38	5.12
Maryland	5.66	1.69	5.46	12.81
Massachusetts[b]	4.87	1.05	3.91	9.83
Michigan	5.63	1.42	1.73	8.78
Missouri	5.55	1.41	2.30	9.26
New York	3.99	.83	1.46	6.28
Ohio	3.77	1.42	2.26	7.45
Virginia	5.60	2.30	6.50	14.40
Wisconsin	2.20	.54	.66	3.40

[a] Based on annual reports of state banking departments. Figures are as of December 31, 1937, unless otherwise indicated. Delinquency percentage represents the unpaid principal on all delinquent accounts expressed as a percent of the unpaid principal on all outstanding accounts.
[b] September 30, 1937.
[c] September 30, 1936.

that arrive a day or two late. One estimate[9] places delinquency at 15 percent—measured, as is customary in the business, as the ratio of unpaid principal on all delinquent accounts to the unpaid principal on all outstanding accounts; but this estimate includes accounts delinquent on principal alone, as well as those delinquent on both principal and charges. Only the latter type of delinquency is included in the annual reports made by licensees to state supervisors. Table 17 shows this delinquency in a number of states as of the end of 1937 (in Florida and Maine, September 30, 1936). In some

[9] Robinson and Nugent, *op. cit.*, pp. 211-12.

states such delinquency approaches the estimated 15 percent total delinquency.

In order to eliminate technical delinquency the Household Finance Corporation now classifies as delinquent only those accounts which at the end of the month have had no payments made on them since the nineteenth day of the preceding month, thus allowing an average period of grace of about twelve days after the nominal due date. Mainly because of this change in definition, but also because of a healthier condition of accounts, average delinquency declined from about 15 percent during 1929-34 to about 5 percent in 1935 and subsequent years. This change in the method of measuring delinquency has affected chiefly the figures for "delinquency on both principal and charges," which declined from 7.44 percent in 1934 to 1.83 percent in 1937; "delinquency on principal alone" was less than half the other type until 1932, but is now about twice as large.

Analysis reveals that, on the average, loans to schoolteachers fall into delinquency three times as often as those secured by household goods or automobiles, or the unsecured notes of others than schoolteachers. Practically all of this delinquency on teacher loans is concentrated in the summer months, and is sufficient to introduce a very pronounced seasonal movement into the picture of total delinquency. Yet delinquency on these loans rarely leads to loss of principal. It occurs largely because teachers are not paid during the summer, and because many travel or are otherwise away from home. While such delinquency is real and inconveniences the lender, it differs radically from the type of delinquency that produces collection expense and possible charge-off.

Technical delinquency and delinquency on loans to schoolteachers thus give rise to an overstatement of true delinquency, but on the other hand there are "hidden slows"—accounts that have made only partial payment on principal but are not counted delinquent.

Refinancing

Refinancing occurs when borrowers cannot meet payments due or when they seek additional funds before an existing loan is paid off. In the first case, preceded usually by a period of delinquency, the lender gains more by adjusting the terms of payment than by attempting to enforce immediate collection of the entire unpaid balance, even though the latter is legally due in full as soon as an account becomes delinquent. In the second case the adjustment is made at the borrower's request and is an accommodation to him. A loan refinanced without additional funds is termed by lenders a "straight renewal"; one entailing new credit is a "loan to a present borrower."

When a loan is refinanced an entirely new contract is drawn, usually with the same terms of payment as the original. In straight renewals, assuming that at least one payment has been made before renewal, the effect of refinancing is of course to reduce the size of the monthly payment.[10] Renewal loans are comparatively rare; in the business of one lender they amount to less than 1 percent of all loans made. On the other hand, the refinancing of loans to present borrowers in order to provide them with additional funds is of considerable importance; in the business of two chain lenders such loans amount to more than 60 percent of all loans made.

Foreclosure

If the lender holds a chattel mortgage on property of the borrower, delinquency may lead to foreclosure. Although frequently threatened, actual foreclosures are fewer than might be expected. As can be seen in Table 18, total amounts due on foreclosed accounts in 5 states were less than 1 percent of outstandings in 1936; and in general the voluntary surrender of furniture by borrowers occurred more frequently

[10] Ordinarily, but not always. A new contract might be drawn to run for a much smaller length of time than the original contract.

TABLE 18

AMOUNT DUE AT TIME OF FORECLOSURE ON CHATTEL MORTGAGES AND BILLS OF SALE, AND AMOUNT REALIZED, IN SELECTED STATES, 1936[a]

State	Due on Furniture Taken When in Use[b]	Due on Furniture Taken When Not in Use[b c]	Due on Furniture Not Recovered[b]	Total Amount Due		Amount Realized in % of Amount Due
				Percent[b]	Dollars	
Kentucky	.06	.13	.05	.24	$ 6,100	26.1
Massachusetts[d]	.01	.15	.01	.17	28,735	66.7
Michigan[e]	.20	.08	[f]	.28	63,531	61.6
Nebraska[e]	.24	.43	.05	.72	40,938	52.2
Virginia	.02	.05	.05	.12	6,304	30.5

[a] Based on annual reports of state banking departments, for calendar year 1936 unless otherwise specified.
[b] Amount due at time of foreclosure in percent of total loan balances outstanding at end of year. A more useful ratio would be one based not on total outstanding loans but on outstanding loans secured by chattel mortgages on furniture. This is possible only for Michigan, and there the understatement caused by using total outstandings amounts to 51 percent. For Kentucky, Massachusetts and Virginia the closest approximation to outstanding loans secured by chattel mortgages on furniture is outstanding chattel mortgage loans in general, and if data on these loans are used as a basis the figures in the table are found to represent understatements of 31, 31 and 90 percent respectively.
[c] Furniture taken when not in use is either abandoned or released by owner.
[d] Year ending September 30, 1936.
[e] Data for 1937.
[f] Less than 0.005 percent.

than actual foreclosure, though the distinction between these two situations may be finer than the lenders imply. The necessity for maintaining community goodwill makes foreclosure a hazardous policy, and the low resale value of used furniture and household goods also causes the lender to avoid foreclosure wherever possible. In regard to the latter point, Table 18 shows that the ratio of amount realized on recovered chattels to amount due on unpaid balances ranged from 26 to 67 percent. Deficiency judgments for the balance are of little practical value, and therefore are seldom obtained.

Charge-off of Bad Debts

The practice followed in charging off loans as losses varies widely among lenders. Loans charged off as losses are typically those on which a resumption of principal payments is not expected, but lenders often err in judging loans as losses and subsequently recover all or part of the amount charged off. The usual test of loss is the period of time during which payments have been delinquent, though loans not delinquent are charged off in some cases because a change in the borrower's status definitely presages a long interruption or a complete breakdown of principal payments. To illustrate charge-off practices and experience we rely mainly on data furnished by the Household Finance Corporation, acknowledging that its methods of operation may differ in some respects from those of other lenders.

Although charged-off accounts are not necessarily delinquent, and although delinquent accounts are not always charged off, it is reasonable to expect a significant degree of relationship between delinquency and charge-offs. This relationship cannot be measured directly from available data, but it is possible, as an approximation, to relate delinquency to "bad-debt loss." In any given year the latter is obtained by subtracting from total charge-offs the amount recovered in that year. This method does not accurately state the loss for that year, however, since there may be a lag between charge-off and recovery, the two not necessarily occurring in the same year.

Table 19 presents figures on delinquency and bad-debt losses experienced by the Household Finance Corporation and the American Investment Company of Illinois. Since the two companies use different definitions of delinquency their respective data are not comparable.

The year-to-year movements of the delinquency and bad-debt figures for the Household Finance Corporation are sufficiently alike, notwithstanding the discrepancies men-

TABLE 19

LOAN DELINQUENCY AND BAD-DEBT LOSS OF 2 PERSONAL FINANCE CHAINS, 1923–37, IN PERCENT OF MONTHLY LOAN ACCOUNT[a]

	Loan Delinquency[b]		*Bad-Debt Loss*[c]	
Year	Household Finance Corp.	American Investment Co. of Ill.[d]	Household Finance Corp.	American Investment Co. of Ill.
1923	6.13	...	.59	...
1924	6.38	...	.80	...
1925	6.58	...	.86	...
1926	6.84	...	.90	...
1927	7.02[e]	...	.86	...
1928	10.68[e]	...	1.50	...
1929	9.22	...	1.58	2.14
1930	10.48	11.45[f]	1.81	1.51
1931	13.55	12.93[f]	2.21	1.76
1932	19.43	17.86[f]	5.39	3.11
1933	21.08	22.01[f]	6.18	3.16
1934	13.41	13.52[f]	4.13	4.17
1935	10.60[g]	10.09[f]	1.24	2.26
1936	8.60[g]	8.46	−.83	1.36
1937	10.28[g]	9.91	.37	1.52

[a] Based on data supplied by the two companies. For the American Investment Company data are not available for the earlier years of the period.

[b] Twelve-month average.

[c] Annual figure.

[d] An account is considered one month delinquent on the first day of the first month following a due date on which full payment of charges and of principal was not received. Thus accounts not paying full charges and principal, or paying charges only, or charges and part of principal, all become one month delinquent on the first of the following month. An account is classified as two months delinquent on the first day of the second month following the lapsed payment. This method hides a certain amount of delinquency, on the average about 15 days, but actual delinquency is overstated when it is registered. For example, a payment due on May 15, if not paid, is not registered as delinquent until June 1, but at that time it is called one month delinquent.

[e] Before 1928 figures are for delinquency on principal and charges. In 1928 and all subsequent years the figures include delinquency on principal alone as well as on principal and charges. In 1928 average delinquency on principal alone was 2.99 percent of average loan account.

[f] No automobile loans included.

[g] In 1935 the Household Finance Corporation changed its method of measuring

tioned above, to indicate a rather close connection between delinquency and charge-off. In twelve of the fourteen year-to-year changes both series move in the same direction, and a computation of link relatives[11] for both series shows that in seven of the fourteen changes the degrees of change are almost identical; the 1925-26 link relative, for example, is 1.040 for delinquency and 1.047 for bad-debt loss. When the figure on bad-debt loss for any given year is compared with the figure on delinquency for the preceding year—thus allowing for a one-year lag between delinquency and charge-off—the correlation of year-to-year change is definitely weakened. This indicates that the period between delinquency and charge-off is not very great.

The delinquency and bad-debt figures for the American Investment Company move in the same direction in six of the seven times for which data are available. A comparison of the link relatives shows that the degrees of change are closely similar for two years, very dissimilar for one year and fairly close for four years. For the American Investment Company, as for the Household Finance Corporation, a comparison of the bad-debt figure for any given year with the delinquency figure for the preceding year shows the correlation of year-to-year change to be much less close.

Data on the length of delinquency prior to charge-off are shown for the Household Finance Corporation in Tables 20 and 21. In Table 20 delinquency is classified according to the usual practice of measuring it from the last date on which some payment was received, either on principal and charges

[11] Link relatives are derived by dividing the figure for any one year by that of the preceding year.

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delinquency. Formerly all accounts which failed to make any payment during the month were considered to be delinquent. Under the present method delinquent accounts are all those on which, at the end of the month, no payment has been received since the nineteenth day of the preceding month. In the interests of comparability the figures for 1935–37 have been adjusted upward according to a formula supplied by the company. The unadjusted ratios reported for these years are 5.35, 4.31 and 4.79.

TABLE 20

PERCENTAGE DISTRIBUTION OF NUMBER OF ACCOUNTS CHARGED OFF BY A PERSONAL FINANCE CHAIN, 1935–37, BY NATURE OF DELINQUENCY AT TIME OF CHARGE-OFF[a]

Nature of Delinquency	*Dec. 1935*	*June 1936*	*Dec. 1936*	*June 1937*	*Dec. 1937*
Not delinquent	23.8	19.5	16.8	12.3	11.1
Delinquent on principal only, 40 days or more	15.5	12.9	12.1	10.8	10.3
Delinquent on charges and principal					
40–59 days	20.9	17.3	16.9	16.3	18.3
60–89 days	11.0	16.0	13.9	17.3	17.4
90 days or more	28.8	34.3	40.3	43.3	42.9
TOTAL	100.0	100.0	100.0	100.0	100.0

[a] Based on data supplied by the Household Finance Corporation. Delinquency is measured from the last date on which some payment was received, either on principal and charges or on charges alone.

TABLE 21

PERCENTAGE DISTRIBUTION OF NUMBER OF ACCOUNTS CHARGED OFF BY A PERSONAL FINANCE CHAIN, 1935–37, BY EXTENT OF DELINQUENCY AT TIME OF CHARGE-OFF[a]

Months Delinquent	*Dec. 1935*	*June 1936*	*Dec. 1936*	*June 1937*	*Dec. 1937*
1 or less	12.3	12.2	9.2	7.8	7.0
2– 4	30.7	32.7	30.5	33.0	33.8
5– 7	26.3	26.8	32.4	31.7	34.0
8–10	10.6	13.3	11.9	16.1	15.5
11–13	5.1	5.4	5.7	5.3	5.6
14–16	3.3	2.8	2.7	2.3	2.0
17–19	2.1	1.2	1.8	1.1	.7
20 or more	9.6	5.6	5.8	2.7	1.4
TOTAL	100.0	100.0	100.0	100.0	100.0

[a] Based on data supplied by the Household Finance Corporation. Delinquency is measured from date of last payment of charges plus at least half of the instalment due on principal.

or on charges alone. For example, if the last payment was made more than 40 days prior to charge-off, and covered charges but nothing on principal, the charged-off account is included among those "delinquent on principal only, 40 days or more."[12] If nothing had been paid on the account, either on principal or on charges, for more than 40 days but less than 60 days, it is classified as "delinquent on charges and principal, 40-59 days." If the account paid charges and at least something on principal within 40 days prior to charge-off it is classified as "not delinquent." It should be pointed out that this classification overstates the period of actual delinquency, since it measures from the date of the last payment made rather than from the date on which the subsequent payment was due. The terminology of the trade is used here, but it is important to bear in mind that an overstatement is involved.

According to Table 20 more than 40 percent of all accounts charged off in 1937 were delinquent 90 days or more on both principal and charges at the time of charge-off, and about 35 percent were delinquent 40-90 days. About 10 percent of all loans charged off were delinquent on principal only, and another 10 percent were not delinquent at all.

It is reasonable that a substantial proportion of charged-off accounts should show a delinquency of 90 days or more, for lenders will delay charge-off as long as they can afford to keep delinquent accounts on their books. The fact that accounts delinquent on principal alone constituted but 10-15 percent of the total number charged off reflects the expectation of the lender that as long as charges are collected there is some prospect for ultimate repayment of principal. In fact, it may be asked why accounts on which charges are being met are written off at all. There are several possible explanations: perhaps only a portion of the charges is being met each month; the

[12] Some of the accounts in this class are delinquent also on part of the interest charges due.

expense of attempting to collect amounts due on principal may be excessive and refinancing inexpedient; the company may consider it inadvisable to allow borrowers to pay charges indefinitely, for this practice is actively opposed by state regulatory authorities and, if publicized, may arouse unfavorable public sentiment.

It is rather surprising that as many as 11-24 percent of all charged-off accounts are recorded as not being delinquent at the time of charge-off. In a few cases this is explained by the death of the borrower, leaving no one legally responsible for the debt, but probably the chief explanation is that borrowers are not nominally delinquent when they make at least some small payment on principal in addition to charges, and the expense of collecting even this amount may be too great to justify continuing the account.

Table 21 provides a somewhat different statement of delinquency at time of charge-off, reckoning it from the time of the last payment of charges plus at least half of the instalment due on principal. By this definition average delinquency is somewhat longer, because charge-off usually occurs a longer time after the last payment of half or more of a principal instalment than after a smaller fractional payment; in other words, payments frequently begin to fall off before they cease altogether. Even under this definition, however, well over two-thirds of all delinquent accounts are charged off after 7 months of delinquency or less.

It may reasonably be inferred from Tables 20 and 21 that delinquency is expensive to the personal finance lender and that an experienced company is reluctant to carry delinquent accounts as assets for any extended period.

Charge-offs as an Expense of Lending

Since the inauguration of licensed lending some twenty years ago, bad-debt losses on personal small loans have declined substantially. Illegal lenders charged such exorbitant rates of

interest that they could afford to lose large amounts on principal. They could allow indefinite delinquency on principal as long as these interest charges were paid; in fact, delinquency was rather to the lender's advantage than otherwise, for the total amount of interest collected usually exceeded the principal many times over. Licensed lenders, however, operate within narrower profit margins, and must keep bad-debt losses correspondingly low.

It has been estimated that before the depression of 1929-33 bad-debt losses of licensed chattel lenders averaged less than 2 percent of total outstanding loans, and those of endorsed-note lenders less than ½ percent.[13] In the depression years reported loss ratios rose to about 5 percent, but substantial recoveries on charged-off accounts were subsequently made. As has already been indicated (Table 19), in each year from 1923 through 1927 the bad-debt losses of the Household Finance Corporation amounted to less than 1 percent of the average investment in loans. By 1933 this proportion had risen to a peak of over 6 percent, but recoveries subsequently made caused repayments to exceed charge-off losses in 1936 and helped to reduce losses to 0.37 in 1937. Figures for the American Investment Company do not show such a wide range, but they too reflect very clearly the effects of the depression years.

Though small in proportion to total outstandings, bad-debt losses form a substantial item in the total operating expenses of personal finance companies. One authority quotes testimony, given before the Virginia Corporation Commission, to the effect that 17.75 percent of the expenses of 52 small loan corporations in that state arose from bad debts during the period 1927-30.[14] Data covering all states for which the figures are available show that bad-debt losses of all reporting per-

[13] Robinson and Nugent, *op. cit.*, p. 197.
[14] M. R. Neifeld, *The Personal Finance Business* (1933) p. 207.

sonal finance lenders averaged 10.3 percent of total expenses in 1929, 22.7 percent in 1932, and 10.6 percent in 1936.[15]

It is of course true that actual bad-debt losses constitute a small proportion of total expense compared to the costs of preventing these losses, that is, costs of investigation and collection, and therefore an index of loss provides no indication of the general operating efficiency of a lender. But other things being equal, one criterion of the efficiency of a given office is the extent of its bad debts compared with the average experience of similar offices in the business.

Repayment Record of a Sample of Loans

An especially clear picture of operating methods and collection experience in the personal finance business appears in the repayment record of a large sample of loans extended by the Household Finance Corporation, as presented in Table 22. The sample covers 30,951 original loans to new and former customers and 59,379 loans to "present" borrowers (those who substitute a present contract by a new one, either with or without the advance of additional cash) made during the year ending July 31, 1935.[16]

The prevalence of "repeat" borrowing, which has already been mentioned, is confirmed by this sample: 58 percent of the loans extended to new and former customers were terminated by fresh loans; and for loans to present borrowers—those who had already replaced at least one loan by another—the percentage so terminated was even higher, 74 percent. This indicates that repeat customers are more likely than other borrowers to terminate the second loan by a third. More than four out of five present customers who terminated their

[15] See Table 31, p. 110. These ratios of bad-debt losses to total expenses have been computed by dividing the ratio of bad-debt loss to average employed assets by the ratio of total expense to average employed assets.

[16] These figures represent all loans made by 32 offices distributed over the territory served by this company. All the loan contracts included were repayable in 20 months, except about 8 percent for $50 or less, which were repayable in 10 months.

TABLE 22

REPAYMENT RECORD OF A SAMPLE OF LOANS MADE BY A PERSONAL FINANCE CHAIN DURING THE YEAR ENDING JULY 31, 1935[a]

Age of Contract When Terminated[b]	*Contracts Terminated by Cash Payment*		*Contracts Terminated by New Loan*		*Contracts Terminated by Charge-off*		*Total Contracts Terminated*	
	Percent of Original Number	Cumulative Percent	Percent of Original Number	Cumulative Percent	Percent of Original Number	Cumulative Percent	Percent of Original Number	Cumulative Percent
	30,951 CONTRACTS MADE WITH NEW AND FORMER CUSTOMERS							
1 – 6	14.08	14.08	25.38	25.38	.11	.11	39.57	39.57
7 – 12	13.32	27.40	24.74	50.12	.44	.55	38.50	78.07
13 – 18	6.04	33.44	6.69	56.81	.33	.88	13.06	91.13
19 – 24	7.38	40.82	1.02	57.83	.12	1.00	8.52	99.65
	59,379 NEW CONTRACTS MADE WITH PRESENT BORROWERS[c]							
1 – 6	6.74	6.74	30.71	30.71	.14	.14	37.59	37.59
7 – 12	6.18	12.92	33.67	64.38	.52	.66	40.37	77.96
13 – 18	4.33	17.25	8.49	72.87	.36	1.02	13.18	91.14
19 – 24	6.78	24.03	1.32	74.19	.17	1.19	8.27	99.41

[a] Based on data supplied by the Household Finance Corporation, covering all loans made in 32 branch offices.
[b] Number of months after month of origin.
[c] These contracts are of two kinds: those which involve the advance of additional cash, combining the obligation for the new cash with the unpaid balance on the old loan; and those (renewals) which extend the time of payment, reduce the amount of the monthly principal payment, or effect adjustments or settlements. In a renewal loan the borrowers receive no additional cash.

contracts by new loans did so within 12 months; almost half of the new and former customers and around two-fifths of present borrowers who repeated their borrowing did so within 6 months.

Many loans, of course, were repaid fully in cash. In the present sample these amounted to about 40 percent of the loans made to new and former customers, and 24 percent of those made to present customers. Repayment of loans before the scheduled maturity was not at all uncommon: among the loans terminated by cash payment about two-thirds of those to new and former customers, and about half of those to present customers, were retired within a one-year period.[17] The average contract life of the loans in this sample was 19.2 months, but at the end of 12 months some 27 percent of all new and former borrower loans and 13 percent of all present customer loans had been fully repaid in cash, and by the end of 18 months over 33 percent of the former and 17 percent of the latter had been so repaid.

It would be interesting to know how many previous loans repeat borrowers had already received. Supplementary data furnished by the same lender, covering 21,843 loans paid off during 1937 and 1938 in New Jersey, where the maximum legal contract length is shorter than the average—15 months—bear on this point. Roughly one out of every three repeat borrowers repaying their loans with cash had one previous loan; one out of every five had two previous loans; and one out of every two had three or more previous loans.

From these two sets of data it seems fair to conclude that present borrowers, to whom practically two-thirds of these sample loans were made, afford a steady source of demand for the credit of personal finance lenders.

According to the sample of contracts in Table 22—originating, it is true, in a period of rising employment and industrial

[17] Allowance must be made in these percentages for the fact that the sample data include a few loans of $50 or less which carried a 10-month, rather than a 20-month, repayment term.

activity, from loan offices located in populous industrial centers—only 1 percent of the loans to new and former customers, and a fractionally higher percent of those to present customers, were terminated by charge-off. For both groups the proportion of contracts terminated in this manner was lower in the first and last six months of the contract life than in the intervening periods. The outstanding fact regarding collection experience, however, is that under careful loan administration the proportion of personal loans charged off is extremely small for all classes of borrowers and for all lengths of contract. The ultimate credit control problem of the personal loan company is to keep this crucial percentage low.

4

Credit Standards

FROM the lender's standpoint a high-quality loan is one that has a good probability of repayment without delinquency, and a possibility of some recovery in the event of unavoidable default. Although most personal loans are secured by a mortgage on household chattels, the market value of this security has usually been found insufficient to cover the unpaid balance in cases of default. Consequently the lender must choose carefully among potential borrowers in order to avoid costly collection problems. In extending personal finance credit, consideration must be given to the incomes of borrowers and to their trustworthiness as evidenced by their readiness to meet monthly charges fully and promptly. The important items, then, on which the lender must pass judgment include broadly: the size of the borrower's income, and expectations as to its stability; the relation of the amount of the instalment payment to the borrower's income and to his expenditure pattern; the borrower's credit record; the value of the chattel items that the borrower offers as collateral, or the financial responsibility of a comaker; the borrower's other assets, debts and family obligations. From cumulative experience in extending and collecting loans the personal finance lender has necessarily developed certain rule-of-thumb standards in evaluating these risk elements.

Any factual discussion of credit standards in this field must necessarily be based on the experience of the larger companies; their extensive operations compel careful control of credit risk, and from time to time they subject their lending records to a systematic sifting in order to modify their lending

standards in the light of experience. The principal quantitative data used in the following discussion, covering various years in the period 1933-37, have been generously furnished by one of these chain lenders, the Household Finance Corporation,[1] whose offices, including a few in Canada, numbered 228 at the end of 1937. Since the data reflect the lending policies of a single company they are not necessarily representative of the experience of all lenders, and must be interpreted with this qualification. Thus, for example, the average loan made by this particular chain company is somewhat larger than that made by many other lenders. Moreover, its operations in the United States are confined to 17 states, located in the middle western and eastern sections. The data are the most comprehensive available, however, and they are utilized here to illustrate the type of credit problem with which the personal finance lender must cope and the kind of credit standards he must apply.

Each loan made by a lender can be described in terms of the characteristics of the borrower and of the contract. The credit problem thus resolves itself into this question: what is the relative importance, as indicators of credit risk, of the various characteristics of the borrower and of the loan contract? In the following pages charge-off experience on small loans is analyzed with this question in mind. It should be remembered, however, that not all pertinent factors are capable of statistical measurement; there are also intangible elements that only the expert judgment of the loan office manager can appraise.

PROCEDURE IN ANALYSIS OF CHARGE-OFF EXPERIENCE

The method of analyzing charge-offs requires brief explanation. For each of the principal characteristics of borrowers

[1] This company is hereafter referred to in the text of this chapter as the "source lender."

and loans the charge-off experience recorded for each individual subclassification is compared with the average for all. Thus when loans are classified according to the income of the borrower the charge-off experience recorded for any one income group of borrowers is compared with the average for all income groups.[2]

The average charge-off experience for all subclassifications combined is measured by the charge-off percentage, that is, the percentage relation between the total number of loans charged off and the total number of loans made; the charge-off experience of each individual subclassification is measured in the same way—by the percentage relation between its number of charge-offs and its number of loans. In the following discussion, however, we have used not these percentage relationships but an "index of charge-off experience" to show the relative performance of each subclassification and of all combined. This index is computed by dividing the percentage arrived at for each subclassification by the average percentage arrived at for all subclassifications combined, and subtracting 100. The index is thus merely a record of the deviation from average experience, a plus value indicating worse than average and a minus value indicating better than average charge-off experience in comparison with that of all subclassifications combined. Such indices were computed separately for each year in the particular period that was covered in each classification, and were averaged by taking the arithmetic means of the values for the entire period.

In some classifications we show also the percentage distribution of all loans made. The degree of concentration of loans does not directly affect the values of the index, but the extent

[2] For this analysis we have adopted the method of stating charge-off experience originally developed by the Household Finance Corporation and embodied in the tabulations it furnished to us. We are indebted to Burr Blackburn, Director of Research of the Household Finance Corporation, Wilfred Helms of the Statistical Department, and Theodore Yntema, consulting statistician, for many criticisms and suggestions concerning the interpretation of this material.

to which loans are concentrated in a particular subclassification indicates the degree of importance that should be attached to the index number for that class.

CHARGE-OFF EXPERIENCE BY STATUS OF CUSTOMER

One significant classification of personal finance company customers is according to their status as borrowers, that is, whether they are "new" customers (those borrowing from this lender for the first time), "former" customers (old customers returned), "present" customers (those who refinance an unpaid balance and receive an advance of additional funds)[3] or "renewal" customers (those who refinance an unpaid balance without advance of additional funds). A study of customer status, made by the source lender for the years 1934-37 and presented in Table 23, shows that new borrowers constituted 24 percent, former borrowers 14 percent, present borrowers 61 percent, and renewal borrowers only 1 percent of all customers during this period.

The logic of this distribution is revealed by the record of charge-off experience for these various types of borrowers, also presented in Table 23. That the risk-quality of new borrowers is relatively uncertain, even after rather careful investigation, is indicated by the fact that charge-offs of loans to new borrowers are more numerous than average. Former borrowers, on the other hand, may reasonably be supposed to include only those who in their previous loans have lived up to contract terms, and thus it is not surprising that the best relative experience with collections is associated with loans to this group. Loans to present borrowers provide additional money for customers already engaged in amortizing a previous commitment, and inasmuch as lenders would doubtless not be

[3] It should be noted that for the purposes of this chapter "present" customers are defined more narrowly than in the preceding chapter, for "renewal" customers, formerly included, are here considered as a separate classification.

TABLE 23

CHARGE-OFF EXPERIENCE OF A PERSONAL FINANCE CHAIN, 1934–37, BY STATUS OF CUSTOMER[a]

Status of Customer	*Average Size of Loan*	*% Distribution of Number of Loans Made*	*Index of Charge-off Experience*[b]
New customers	$ 137	*24.1*	+ *19*
Non-teacher		22.6	+ 19
Teacher		1.5	+ 19
Former customers	131	*13.6*	– *50*
Non-teacher		12.4	– 49
Teacher		1.2	– 67
Present customers[c]	189	*61.3*	– *6*
Non-teacher		57.0	– 4
Teacher		4.3	– 17
Renewal customers[c]	148	*1.0*	+*408*
Non-teacher		.9	+408
Teacher		.1	+384
All customers	169	*100.0*	
Non-teacher		92.9	+ 1
Teacher		7.1	– 16

[a] Based on data supplied by the Household Finance Corporation.
[b] Obtained by dividing each charge-off percentage by the average percentage for all combined, and subtracting 100; the result shows each level's deviation from the average of all levels, the plus indicating worse than average and the minus indicating better than average experience.
[c] "Renewal" customers were not segregated from "present" customers before 1936. Average loan to renewal customers and indices of charge-off experience for both types are for the period 1936–37 only.

willing to extend the new loan unless the customer's past record were satisfactory, experience with such borrowers is relatively good. The renewal of an existing balance, however, usually occurs only when the lender is already experiencing difficulty in collection, and such loans, even after adjustment, result in relatively more frequent charge-offs than any other type.

A comparison of charge-off experience according to cus-

tomer status must take into account the fact that the size and various other characteristics of the loan may have a bearing upon the results.[4] According to Table 23, however, the average size of loan does not explain the differences in the indices of charge-off experience for the various types of borrowers.[5] Although the average loan to present borrowers is nearly 40 percent larger than the average loan to new borrowers, the index of charge-off experience is markedly better for the present borrower class; the average loan to former customers is only about 5 percent smaller than that to new customers, but it shows a strikingly better index of charge-off experience. These facts suggest that although for any one type of borrower differences in size of loan may determine the probability of successful collection, as among different types the size of loan is of secondary importance. The significant determinants of success are rather certain other facts pertaining to the character and condition of borrowers.

Table 23 indicates, finally, that among loans to new borrowers the indices of charge-off experience are identical for teacher and non-teacher loans, but that for all other customers (former, present and renewal) relatively fewer loans to teachers than to non-teachers are charged off. Actually the

[4] According to a special Detroit study including 7,118 loans (discussed below) when the loans are cross-classified by size of loan and customer status each of the four types of customers shows the greatest concentration of loans in the same size group ($100-150). Of loans to new borrowers 36.5 percent were in this size group, and 24.6 percent (the next largest concentration) were in the $50-100 group. Of loans to former borrowers 35.7 percent were for $100-150, but only 27 percent of the loans to present borrowers were of this size. Loans to renewal borrowers were a negligible proportion of the total, but they too showed their greatest concentration in this size group.

This tendency toward concentration in the same size group does not mean that the average size of loan is about the same for the four different types of customers. Table 23 shows a size variation similar to that in the Detroit study, and is based upon a much larger sample; loans to present borrowers are the largest, with renewal loans next, followed by loans to new and former borrowers.

[5] The relation of size of loan to charge-off experience is dealt with in detail in a subsequent section (see pp. 103 ff.). With the exception of $300 loans, the smaller the size the better the charge-off experience.

indices understate the difference between teacher and non-teacher loans for, it will be recalled, these indices are based upon the number of charge-offs in relation to the number of loans. Supplementary figures, not presented here, showing the amount charged off as a percentage of the original amount of all charged-off loans, reveal that even when loans to teachers are charged off, the balance owed on principal at the time of charge-off is a smaller proportion of the original loan than is the case in charge-offs of loans to non-teachers. These factors account for the practice, general among personal finance companies, of viewing schoolteachers as preferred risks.

CHARGE-OFF EXPERIENCE BY SECURITY FOR LOAN

In Table 24, which presents the charge-off experience of the source lender for 1936 and 1937 according to the type of security, loans are classed according to five types of security, but there are only two basic classes—secured and unsecured; teacher loans, note loans and honor loans all fall in the latter category. Teacher loans are made on unsecured notes, the safety of the loan depending on the teaching contract; honor loans are note loans made by the source lender's so-called honor offices, which make only unsecured loans. Nevertheless, classification into five rather than two divisions brings out important differences in charge-off experience.

For the two years covered by these data loans secured by household goods were markedly successful, a record that is particularly significant because in both years such loans amounted to more than four-fifths of all loans made. Since loans secured by automobiles constituted only ½ percent of all loans made, charge-off experience regarding them is of doubtful significance. Teacher loans had a strikingly better charge-off record than either secured loans or the other unsecured types. This favorable record is doubtless due to the relative stability of position and income enjoyed by this pro-

fession, and to the fact that usually teachers are employed only after careful examination of their character and responsibility.

The relatively more successful record on honor loans than on note loans may be ascribed to the fact that the former are made to all types of people in the community, while note loans are made to single persons and married people who do not possess furniture. The latter probably constitute a less stable group of borrowers.

TABLE 24

CHARGE-OFF EXPERIENCE OF A PERSONAL FINANCE CHAIN, 1936 AND 1937, BY SECURITY FOR LOAN[a]

Type of Security	*1936*		*1937*	
	% Distribution of Number of Loans Made	Index of Charge-off Experience[b]	% Distribution of Number of Loans Made	Index of Charge-off Experience[b]
Teaching position	6.7	− 20	5.7	− 46
Household goods	81.7	− 17	82.6	− 19
Automobile	.5	− 8	.5	+ 10
Honor	3.8	+130	4.2	+102
Note	7.3	+143	7.0	+196
TOTAL	100.0		100.0	

[a] Based on data supplied by the Household Finance Corporation.
[b] See Table 23, footnote b.

CHARGE-OFF EXPERIENCE BY INCOME OF BORROWER

Data on the relationship between charge-off experience and income of borrower are presented in Table 25, and are supplemented by a special study of all loans made by the source lender's Detroit offices during the first quarter of 1936, shown in Table 26. The latter table, while containing no direct data on charge-offs, presents material essential to their explana-

TABLE 25

CHARGE-OFF EXPERIENCE OF A PERSONAL FINANCE CHAIN, 1934-37, BY INCOME OF BORROWER[a]

Monthly Income[b]	*Average Size of Loan*	*% Distribution of Number of Loans Made*	*Index of Charge-off Experience*[c]
$ 50 or less	$ 92	.8	+102
50 - 100	108	16.5	+ 27
100 - 150	152	33.7	+ 3
150 - 200	191	26.7	- 14
200 - 250	211	11.4	- 30
Over 250	234	10.9	- 35
TOTAL		100.0	

[a] Based on data supplied by the Household Finance Corporation.
[b] Each level is exclusive of the lower figure and inclusive of the higher.
[c] See Table 23, footnote b.

tion, in that it shows the average proportion of the borrower's monthly income which is absorbed by loan payments. Although these data are limited, both as to the period covered and as to the proportion of total personal loan business surveyed, the consistency which they display suggests that they are not the result of random forces.

The outstanding conclusions to be derived from Table 25 are that charge-off experience improves in direct relation to the income of the borrower; that the average size of loan increases in direct relation to the income of the borrower; and, finally, that it is the $100-150 monthly income band that contains the greatest concentration of customers.

Two income factors appear responsible for the better performance on loans to persons in the higher income classes. First, the proportion of income required to meet principal payments on loans declines as the income of the borrower increases; in the Detroit study the amount of income so required ranged from 13 percent for borrowers receiving monthly incomes of $50 or less to 3 percent for those with

TABLE 26

DISTRIBUTION OF 7,118 LOANS MADE BY A PERSONAL FINANCE CHAIN, AND PROPORTION OF BORROWER'S INCOME REQUIRED FOR PAYMENTS ON PRINCIPAL, FIRST QUARTER 1936, BY SIZE OF LOAN AND INCOME OF BORROWER[a]

Size of Loan[b]		*Monthly Income of Borrower*[c]							
		$50 or Less	$50–100	$100–150	$150–200	$200–250	Over $250	Unemployed and not Reporting	Total
Under $50	Number of loans	1	50	87	25	8	6	1	178
	% of income required for payments	4.44	1.92	1.33	.94	.78	.63	..	1.27
50–100	Number of loans	4	245	624	270	94	43	4	1,284
	% of income required for payments	7.06	3.63	2.56	1.89	1.46	1.03	..	2.28
100–150	Number of loans	....	319	1,079	535	176	133	5	2,247
	% of income required for payments	....	5.89	4.44	3.24	2.53	1.84	..	3.70
150–200	Number of loans	1	49	439	294	127	60	4	974
	% of income required for payments	30.00	8.62	6.28	4.77	3.63	2.60	..	4.96
200–250	Number of loans	....	35	434	348	152	163	9	1,141
	% of income required for payments	....	10.69	7.91	5.94	4.66	3.18	..	5.63
250–300	Number of loans	....	6	76	83	39	52	1	257
	% of income required for payments	....	13.86	9.84	7.53	5.90	4.14	..	6.68
300	Number of loans	1	7	168	322	246	286	7	1,037
	% of income required for payments	39.47	15.44	10.99	8.25	6.68	4.34	..	6.54
TOTAL	Number of loans	7	711	2,907	1,877	842	743	31	7,118
	% of income required for payments	13.43	5.47	5.30	4.83	4.31	3.30	..	4.62

[a] Based on data supplied by the Household Finance Corporation, covering the operations of its Detroit offices.
[b] Each size level is inclusive of the lower figure and exclusive of the higher.
[c] Each income level is exclusive of the lower figure and inclusive of the higher.

monthly incomes over $250. Second, the high-income borrower could probably use for repayments an even higher proportion of his income than the borrower in the low income bands, without equal strain, for it is likely that a smaller proportion of the former's income must be assigned to meet basic living expenses. In other words, data on the proportion of monthly income required to meet monthly principal payments do not measure precisely the differences in the financial burden imposed on individuals in different income classes by their borrowing activities: the burden carried by the low income groups is understated because for them other fixed expenses are also more burdensome than they are for the higher income groups.

CHARGE-OFF EXPERIENCE BY OCCUPATION OF BORROWER

During the five-year period 1933-37, as indicated by Table 27, the charge-off experience of the source lender was worse than average on loans to proprietors, unskilled workers and salespersons (and also those for whom no occupation was reported). It was better than average on loans to skilled and semi-skilled workers, to managers, superintendents and foremen, to schoolteachers and others in professional pursuits, persons with independent incomes, and office and clerical workers.

Supplementary data not included in Table 27, covering the source lender's Detroit offices for the first quarter of 1936, show the average size of loan for each occupation, and indicate that the better performance of certain occupational groups was in spite of the fact that their loans were larger, on the average, than loans to the occupational groups in which charge-offs were proportionately more numerous. Occupations listed in Table 27 as having a relatively poor charge-off record received loans ranging from $135 to $185, while those having

TABLE 27

CHARGE-OFF EXPERIENCE OF A PERSONAL FINANCE CHAIN, 1933–37, BY OCCUPATION OF BORROWER[a]

Occupation	*% Distribution of Number of Loans Made*	*Index of Charge-off Experience*[b]
Schoolteachers	7.6	− 21
Office, clerical and other non-manual workers	18.5	− 21
Persons with independent incomes, not employed	1.2	− 20
Professional persons (exclusive of schoolteachers)	2.6	− 13
Managers, superintendents and foremen	10.2	− 6
Skilled and semi-skilled workers	37.5	− 2
Proprietors	10.4	+ 15
Unskilled workers	5.1	+ 33
Salespersons	6.3	+ 54
Not reporting	.6	+105
TOTAL	100.0	

[a] Based on data supplied by the Household Finance Corporation.
[b] See Table 23, footnote b.

a relatively good charge-off record borrowed sums ranging from $144 to $198.

Since the indices shown in Table 27 are five-year averages, they conceal any year-to-year trends that might exist, but study of the separate yearly indices reveals that collections from unskilled workers and, with somewhat less regularity, those from professional persons exclusive of teachers, became relatively more successful over the period. Charge-off records became relatively worse for salespersons and office and clerical workers. Some occupations became relatively worse as credit risks, then better; and others vice versa. The significant contrast lies between the experience with unskilled workers and with office workers, though the trend of the indices for these groups was, in general, what one would expect. During the recovery period income status probably improved more markedly among unskilled workers than in most other groups and, as wages became higher and steadier, defaults logically became

fewer. In contrast, the office, clerical and other non-manual worker groups, comparatively the best risks in the depth of the depression, showed an increasingly poorer charge-off record during the recovery period.

These year-to-year changes in charge-off indices are of doubtful significance, however, because the method of computation is such that a change in charge-off experience for any one group will be reflected in changes in the charge-off indices for all other groups. Thus the increasingly poorer record of office, clerical and other non-manual worker groups may have been due to the improving charge-off record of other occupations. Year-to-year studies of indices are nevertheless useful in showing shifts in the relative positions of various groups as compared to the average for all groups.

Table 28, which presents charge-off experience according to the industrial source of borrowers' income, indicates that postal service, telephone and telegraph, agricultural, railroad and streetcar, public and professional service, and iron and steel groups have provided the most desirable credit risks for the source lender. Mining, truck and taxicab, domestic and personal service, building and construction, food manufacture, and wholesale and retail trade groups account for the poorest credit risks. Borrowers from the groups classified under machinery and transportation equipment, automobile factories, textiles, printing and publishing, banking, insurance, real estate and brokerage, and also those classified as "miscellaneous and not reporting," show about an average charge-off experience.

An examination of the annual indices from which the averages are derived shows that the pattern of behavior for "better than average" industries, with the exception of agriculture in 1933, was consistent throughout the period, as was also that of the four industries having the poorest charge-off record, with the exception of building and construction in 1935. The in-

TABLE 28

CHARGE-OFF EXPERIENCE OF A PERSONAL FINANCE CHAIN, 1933–37, BY INDUSTRIAL AFFILIATION OF BORROWER[a]

Industry	*% Distribution of Number of Loans Made*	*Index of Charge-off Experience*[b]
Postal service	1.5	− 61.0
Telephone and telegraph	1.1	− 54.4
Agriculture	1.9	− 31.1
Railroads and streetcars	7.1	− 28.7
Public service	10.0	− 24.3
Professional service	11.5	− 14.5
Iron and steel	4.9	− 13.8
Machinery and transportation equipment	4.4	− 8.7
Automobile factories	4.8	− 5.2
Textiles	3.4	− 2.2
Printing and publishing[c]	2.5	+ .4
Banking, insurance, real estate, brokerage	4.7	+ 2.3
Miscellaneous and not reporting[d]	16.7	+ 4.1
Wholesale trade	.9	+ 14.0
Food manufacture	5.5	+ 20.2
Retail trade	9.4	+ 24.7
Building and construction	2.4	+ 31.1
Domestic and personal service	4.8	+ 32.9
Trucks and taxicabs	1.7	+ 61.2
Mining	.8	+100.4
TOTAL	100.0	

[a] Based on data supplied by the Household Finance Corporation.
[b] See Table 23, footnote b.
[c] This industry was not segregated in 1933.
[d] "Miscellaneous" includes "other manufacturing," "miscellaneous transportation and communication" and "miscellaneous trade."

dustries in the middle group display such varied patterns that no generalization is possible.

It appears that from the standpoint of successful credit administration the industrial affiliation of a borrower is an important determinant of credit standards, its significance lying in the regularity and security of employment provided by a

given occupation. It is probably true, however, that in judging the relative safety of various credit risks a study of general economic conditions in particular fields of industry is second in importance to a careful investigation of the individual applicant.

CHARGE-OFF EXPERIENCE BY SIZE OF LOAN

The experience of the source lender during 1934-37 was that, in general, charge-offs vary directly with the size of loan.[6] According to Table 29 they are less than average for loans under $100, just average within the $100-150 group, and greater than average for loans of $150 and above. Loans between $250 and $300 have a considerably less successful charge-off record than those of $200-250, but the progression toward a poorer charge-off record is broken at the $300 group, which shows a record only slightly poorer than average. This group merits special attention, because $300 loans constituted about 20 percent of the total number and 36 percent of the dollar volume of all loans made by the source lender during this period, while loans between $250 and $300 were considerably less important, both in number and in volume.

This exception in charge-off experience in regard to $300 loans can perhaps be explained most satisfactorily by reference to the occupational status of those who borrowed the maximum amount permitted. Data derived from the Detroit study referred to above show that approximately 70 percent of the $300 loans were taken by office and clerical workers, managers, superintendents and foremen, owners and managers (proprietors) and schoolteachers. According to Table 27 borrowers in these occupations, with the single exception of owners and managers (proprietors), displayed a charge-off

[6] Table 25 may have given the reverse impression. Indices shown in that table refer to income groups, however, not to average loan within those groups. The higher income brackets have a better record in spite of, not because of, their larger average loan.

TABLE 29

CHARGE-OFF EXPERIENCE OF A PERSONAL FINANCE CHAIN, 1934–37, BY SIZE OF LOAN[a]

Size of Loan[b]	*Average Size of Loan*	*% Distribution of Number of Loans Made*	*% Distribution of Amount of Loans Made*	*Index of Charge-off Experience*[c]
Under $50	$ 34	3.5	.7	−38
50–100	66	16.7	6.5	−14
100–150	115	27.0	18.4	0
150–200	166	13.6	13.4	+ 7
200–250	211	14.9	18.6	+ 9
250–300	265	3.8	5.9	+26
300	300	20.5	36.5	+ 2
TOTAL		100.0	100.0	

[a] Based on data supplied by the Household Finance Corporation.
[b] Each level is inclusive of the lower figure and exclusive of the higher. See Table 23, footnote b.

record better than average (the office and clerical workers and schoolteachers much better than average). There is no such concentration of relatively better risks among the borrowers of $250-300, for whom the distribution by occupation is about the same as that for borrowers of smaller amounts. Unskilled laborers, for example, with a relatively poor charge-off record, account for about the same proportion of $250-300 loans as of those under $50.

A cross-classification of the data, showing the uses to which loans of various sizes are put, reveals that loans for any purpose other than business needs constitute roughly the same proportion of the total, regardless of their size, but that business loans form a considerably higher proportion of $300 loans than of those of any other amount. About 15 percent of the $300 loans, but only 8 percent of the $200-300 loans, are for business needs. Proprietors are the most likely to borrow for this purpose, and since they have a worse than average charge-off record (Table 27) a relatively bad charge-off experi-

ence on $300 loans would seem to be indicated—at least for those obtained to meet business purposes. It seems reasonable to suppose, however, that proprietors who obtain loans of this size are those who have relatively high incomes and are thus the better credit risks, an inference supported by the data in Table 25, which show a direct variation between size of loan and income class. Also, loans of $300 are less likely to be used for basic living expenses, such as rent, than are those of smaller size.

The better charge-off record on $300 loans than on $250-300 loans may be further explained by data presented in Table 26, which shows that approximately 50 percent of the borrowers of $300 had monthly incomes of over $200, while only about 35 percent of those persons receiving loans of $250-300 were in this income class.

There would be a still further explanation of the charge-off experience on $300 loans if these loans were secured mainly by chattel mortgages, while those in the $250-300 group were primarily note loans. The Detroit study does not bear out this hypothesis, however. There were no significant differences in the distributions of various loan sizes by type of security.

The relatively successful record on $300 loans must be explained, then, on the grounds that these loans are most frequently made to persons in occupational classes that provide the better risks, and are most likely to be made to the borrowers with the highest incomes. Differences in credit investigation and collection procedure for loans of different sizes may have a significant influence on charge-offs, but this cannot be expressed in statistical terms.

CHARGE-OFF EXPERIENCE BY CUSTOMER RATINGS

The controls instituted by the large chain lenders have been designed in part to limit bad-debt losses to those that are

unpredictable and unavoidable, and there is reason to believe that such losses are even lower than they are at present estimated to be. The source lender has recently kept records, covering 1936 and 1937, that classify charged-off accounts according to whether they were or were not suspect at the time the loans were made. Terming as "A loans" all those that were considered sound when made, and as "B loans" those that were considered doubtful, the tabulation expresses the number of A loans charged off as a percent of the number of A loans made, and similarly for B loans. The computations were made separately according to the status of the borrower—new, former, present or renewal. It was found that among new borrowers the ratio of B loans charged off to B loans made was between two and three times as great as the ratio between A loans charged off and A loans made; among former borrowers it was about seven times; among present borrowers about five times; among renewal borrowers six to seven times. These proportions obtained in both years covered by the data. It may be inferred from this analysis that among all except new borrowers the likelihood that a B loan will be charged off is at least five times as great as that for an A loan.

The problem of selecting risks is not solved, of course, by this finding, for although the proportion of loans charged off is greater for B loans than for A, the proportion of each which is eventually charged off is relatively small; furthermore, B loans as a whole are a rather small proportion of total loans. Therefore a lender might find it inexpedient to stop making B loans, since the income derived from them may be greater than the additional costs that they entail.

5

Expenses and Income

AN ANALYSIS of the cost structure of personal finance companies is of particular interest because of the fact that lenders so frequently stress the high costs of retailing credit. Assertions to this effect are advanced to support the contention that relatively high rates are essential to profitable operation. In this business, however, earnings too are relatively high, ranging during 1929-36 from 7 to 12 percent of "average employed assets."[1] A record of earnings computed on this basis is not completely satisfactory, yet in the absence of more direct measures it serves as an indication of the profitability of personal finance company operations.

In view of the importance of these aspects of the personal finance business, data are presented in this chapter on the cost structure of personal finance companies, the ratios of gross expenses and income and net income to average employed assets, and the earnings and expenses in loan offices of different sizes and different organizational structures. The next chapter will deal with the related question of costs incurred on loans of various sizes.

EXPENSES

A typical distribution of expenses in the personal finance business is shown in Table 30, which is based on averages of annual data compiled from state banking department and accountants' reports for 1934, 1935 and 1936. Salaries, bad-debt loss, advertising, taxes and rent are the major items of expense in the personal finance business, all other items

[1] The meaning of this term is explained on page 109.

TABLE 30

PERCENTAGE DISTRIBUTION OF EXPENSES INCURRED BY PERSONAL FINANCE COMPANIES, 1934–36[a]

Item	*Percent*
Salaries	38.6
Bad debts and insurance against loss	13.3
Advertising	10.7
Sundry other expenses	9.9
Taxes and license fees	9.4
Rent	5.7
Printing, stationery, postage, telephone and telegraph	4.2
Travel	2.5
Legal fees	2.1
Auditing	1.2
Depreciation on furniture and fixtures	1.1
Insurance and bonding	1.0
Recording and acknowledging fees	.3
TOTAL	100.0

[a] Based on annual reports of state banking departments or, for states in which such reports are not published, on accountants' reports prepared for state associations of personal finance companies from data filed with the state banking department. Data cover 17 states in 1934, 14 in 1935 and 17 in 1936. Expenses do not include interest on borrowed funds or amortization of financing costs and bond discounts.

together accounting for less than one-fourth of total expenses. Salaries, including those of officers, executives, managers, clerical workers and other "inside" men, and also those of "outside" men or credit investigators, are the largest source of expense to the lender, accounting for about 39 percent of the total. Second in size is the item of bad debts and insurance against loss, which, after the subtraction of collections on accounts previously charged off, approximates 13 percent of aggregate expenses. The proportion for bad debts in Table 30, although an average for 1934-36, is probably understated because recoveries were being made in this period on loans charged off during the preceding depression years.

Advertising, the third most important item, absorbed about

11 percent of total expenses, an amount almost equal to that for bad-debt loss. Although personal finance companies engage in widespread advertising in order to attract new customers, a large part of their advertising expenditure is incurred primarily to educate the public in the purposes and functions of the small loan business, and to counteract the frequent attempts to reduce the legal charge for small loans.

The remaining 37 percent of expenses are variously distributed among other cost categories. Taxes, including license fees as well as federal, state and local taxes, averaged 9 percent of total expenses, and rent 6 percent. Personal finance lenders have not the tax-exemption privileges of credit unions, and therefore they contend that their charges must include some provision for the payment of taxes. It is probably for this reason that they report all taxes, including income taxes, as a part of their cost structure.

The only available measure of personal finance company expenses over a period of years is on the basis of "average employed assets." This concept was developed by the Russell Sage Foundation because of the lack of complete data either on entrepreneurial investment (the sum of the balance sheet values of common stock, preferred stock and surplus) or on total investment (the sum of net worth and long-term borrowing). It is computed by multiplying the average of net loan balances[2] outstanding at the beginning and at the end of the year by 1.15 (allowing 0.05 points for cash balances, 0.02 points for furniture and fixtures, 0.02 points for other tangible assets and 0.06 points for cost of development).[3]

In Table 31 the reported items of expense of small loan licensees are expressed as percentages of estimated average

[2] Loan balance minus reserve for bad debts as of the same date.

[3] The multiplier represents a conservative estimate of assets other than loans receivable. This is apparent from M. R. Neifeld's estimates of the balance sheet of personal finance companies, as of December 31, 1936, in which the ratio of assets to loans receivable was 1.25 (*Personal Finance Comes of Age*, 1939, p. 209).

TABLE 31

EXPENSE ITEMS OF PERSONAL FINANCE COMPANIES, 1929–36, IN PERCENT OF AVERAGE EMPLOYED ASSETS[a]

Expense Items	*1929*	*1930*	*1931*	*1932*	*1933*	*1934*	*1935*	*1936*
Salaries	7.46	7.09	6.69	6.80	7.42	7.38	7.41	7.00
Bad debts and insurance against loss	1.81	1.96	2.44	4.27	3.86	3.13	2.41	1.94
Advertising	1.78	1.51	1.69	1.32	1.55	1.87	2.01	2.11
Sundry other expenses	1.67	1.40	1.73	1.69	1.42	1.91	1.61	2.04
Taxes and license fees	1.43	1.29	1.15	1.29	1.62	1.48	1.74	2.07
Rent	1.04	1.06	1.06	1.15	1.22	1.12	1.11	1.01
Printing, stationery, postage, telephone and telegraph	.69	.73	.74	.75	.83	.70	.88	.76
Travel	.38	.45	.44	.44	.50	.39	.54	.48
Legal fees	.20	.34	.31	.31	.43	.41	.42	.36
Auditing	.63	.66	.45	.36	.38	.26	.25	.19
Depreciation on furniture and fixtures	.19	.20	.19	.22	.23	.22	.20	.18
Insurance and bonding	.14	.15	.12	.17	.21	.17	.23	.17
Recording and acknowledging fees	.09	.05	.05	.04	.06	.06	.06	.06
TOTAL[b]	17.51	16.89	17.06	18.81	19.73	19.10	18.87	18.37

[a] Data for 1929–33 based on *Expenses of Small Loan Licensees, 1929–1933*, compiled under the direction of Rolf Nugent, director of the Department of Remedial Loans of the Russell Sage Foundation; data for 1934–36 based on annual reports of state banking departments or on accountants' reports made available to us by the Russell Sage Foundation.

[b] Expenses do not include interest on borrowed funds or amortization of financing costs and bond discounts. The totals listed here differ slightly from "total expenses" in Table 32; the reason is that the present table is based on slightly fewer states, since not all the states included in Table 32 provided a breakdown of expenses.

employed assets over the period 1929-36. Total expenses were fairly steady at about 17 percent during 1929-31, reached their high point of almost 20 percent in 1933 and then gradually decreased to 18.4. Rent followed the same general trend, but remained throughout the period at about 1 percent. Salaries varied slightly around 7 percent throughout the period. Expenses for advertising fell from 1.8 percent in 1929 to 1.3 in 1932, and increased each subsequent year to 2.1 in 1936, suggesting that advertising varies in the same direction as the volume of business but with somewhat greater amplitude. Bad debts and insurance against loss displayed the greatest variation of all the expense items, rising from 1.8 percent in 1929 to 4.3 in 1932, but thereafter declining steadily to only 1.9 in 1936. The item "taxes and license fees" varied irregularly between 1 and 2 percent, reaching its highest point (2.1) in 1936.

The expense items listed in Tables 30 and 31 do not include any provision for interest paid by personal finance companies on their borrowed funds. This expense necessarily varies according to the proportion of total funds obtained by borrowing and the rate of interest that is charged for the use of such funds. Data from 10 selected states show that interest paid by personal finance companies in 1937 ranged from a twentieth to a fifth of all other expenses. If these limited data are representative, and if expenses other than interest typically approximate 18 percent of employed funds—the average indicated by Table 31—then it appears that interest expense in 1937 ranged from 0.9 percent to 3.6 percent of employed assets. Thus it may fairly be inferred that wide variations in the rate of interest paid on borrowed funds have proportionately a much smaller effect on total expenses, including interest, than on earnings, and that therefore personal finance company charges to customers are not particularly responsive to changes in money rates.

GROSS AND NET INCOME

The gross income of personal finance companies is governed primarily by the volume of funds invested in loans and the rates that customers pay for their use. But though these are the basic they are not the only determinants of gross income; failure to make collections on outstanding loans, recoveries on loans previously charged off, legally authorized fee collections and interest on bank balances also affect the gross income of the licensed lender.

By far the major component of gross income is the charges collected on loans. This item varies narrowly among states; in 1937 it averaged, for 15 states, 97.5 percent of gross income.[4] Collections on accounts previously charged off[5] constituted 2 percent of gross income for that year, and interest on bank balances, authorized fees and "other income" accounted for the remaining 0.5 percent.[6]

In Table 32 gross income is expressed in percent of average employed assets. From 1929 through 1933 the ratio declined, mainly, it would appear, because of the increased difficulty during these depression years of collecting all charges due on loans;[7] rate competition among lenders may also have contributed to the reduction in the gross income percentage but data for assessing the importance of this factor are not available. In any event gross income in relation to average employed assets began to rise again in 1934.

Net income in percent of average employed assets, as shown in Table 32, does not indicate return on entrepreneurial

[4] According to Neifeld's estimates (*ibid.*, p. 210) this relationship was 97 percent for all licensed lenders in 1936.

[5] This item is not included in gross income in Table 32 because in computing total expenses it was deducted from the expense item "bad debts and insurance against loss."

[6] These data covering 15 states are based on annual reports of state banking departments or, for states in which such reports are not published, on accountants' reports prepared for state associations of personal finance companies from data filed with the state banking department.

[7] See Neifeld, *op. cit.*, pp. 223-24.

TABLE 32

GROSS INCOME, TOTAL EXPENSES AND NET INCOME OF PERSONAL FINANCE COMPANIES, 1929–36, IN PERCENT OF AVERAGE EMPLOYED ASSETS[a]

Year	*Gross Income*	*Total Expenses*[b]	*Net Income*
1929	28.6	16.9	11.7
1930	27.8	16.4	11.4
1931	27.3	17.0	10.3
1932	26.5	18.8	7.7
1933	26.0	19.3	6.7
1934	26.9	19.1	7.8
1935	27.9	18.8	9.1
1936	27.3	18.3	9.0

[a] Data for 1929–33 based on L. N. Robinson and Rolf Nugent, *Regulation of the Small Loan Business* (1935) pp. 241–42; data for 1934–36 based on annual reports of state banking departments or on accountants' reports made available to us by the Russell Sage Foundation.

[b] Expenses do not include interest on borrowed funds or amortization of financing costs and bond discounts. The figures for total expenses differ slightly from the totals in Table 31; the reason is that Table 31 is based on slightly fewer states, since not all the states included in the present table provided a breakdown of expenses.

investment in personal finance lending; it does indicate, however, the magnitude and direction of fluctuations in the profits derived from this type of credit business. The net income percentages in this table have been derived by subtracting the percentages for total expenses from those for gross income; thus the fluctuations in the net income figures may be understood from the other two items.[8] During 1929 through 1933, when the gross income percentage declined, that for total expenses tended to increase; in 1934 and 1935, when the gross income percentage rose, that of total expenses fell. The result, of course, was a decline in the net income percentages during the former period, and an increase during the latter. It has already been indicated that the decrease in the gross income percentages during the depression was

[8] In state reports interest on borrowed funds is not included among expense items, and therefore net income percentages are to that degree overstated.

probably due primarily to a current decline in the ratio of charges collected to charges earned; as was shown in Table 31, the increase in the expense percentages during this period was due principally to a rise in the loss from bad debts and to some extent, during 1933, to an increase in salary expense. In 1934-35, on the other hand, collections improved and at the same time bad-debt losses were considerably reduced.

In 1936, although the total expense percentage continued to fall, there was a slight decline in that for net income. This is traceable to the interesting fact that in 1936 the gross income percentage, for the first time since 1930, moved in the same direction as that for expenses. It is significant to note that the general tendency of the gross income and expense percentages to move in opposite directions has the effect of augmenting the movement of the net income percentage: when it decreases it falls more, and when it increases it rises more, than it would if gross income and expense moved in a more direct relationship with each other.

SIZE AND TYPE OF LOAN OFFICE AS FACTORS IN EARNINGS AND EXPENSES

The relative profitability of offices of different sizes, measuring size by total assets employed, may be examined in Tables 33 and 34 for the two industrial states of Illinois and New Jersey. The net return, in percent of year-end employed assets, tends to vary directly with size of office. In New Jersey this was true for offices of all sizes up through $400,000, though those with employed assets over this amount showed a slightly lower net return than did those with assets between $300,000 and $400,000. In Illinois the only offices that contradicted the trend were those of less than $10,000 assets and those of $75,000-100,000. This tendency for profits to increase with size is doubtless due in part to the operating economies that are associated with larger volume, and it justi-

fies the emphasis placed on volume by personal finance lenders. There is confirmation, however, of the chain lenders' contention that the business has not yet clearly established an optimum or most profitable size of office.

To account further for this relation between profitability and office size the relation between the gross earnings percentage and office size should be noted. In Illinois this percentage rose fairly steadily from 23 for offices in the $10,000-25,000 class to 31 for offices having assets above $400,000; in New Jersey it rose from 14 for the $25,000-50,000 offices to 27 percent for those in the $300,000-400,000 class, but it was only 21.5 for larger offices. In New Jersey, however, the smallest offices ($10,000-25,000) showed a higher gross earnings percentage than did the next larger offices, and in Illinois the smallest offices (under $10,000) had the best record in this respect of any offices except those over $400,000. The favorable earnings record shown by very small offices may be due to the fact that such offices are frequently operated as adjuncts to one or more other businesses, such as real estate or automobile financing.

Along with the general tendency for the gross earnings percentage to increase is a corresponding and more pronounced tendency toward a decline in total expenses in percent of gross earnings. Although there is some variation in their behavior, salary and bad-debt loss percentages tend to decrease as size of office increases. Miscellaneous other expenses tend to decline to medium-size offices, then increase, and decline again for the larger offices.

In Illinois offices of all sizes showed a profit return on total year-end assets employed, the lowest yield being 3.9 percent for $10,000-25,000 offices. In New Jersey this group (the smallest size class in the state) had a net deficit of 8.5 percent. The next three size classes (offices from $25,000 to $100,000) showed net returns ranging from 1.7 to 2.0 percent in New Jersey but from 5.9 to 8.7 percent in Illinois. This differential

TABLE 33

EARNINGS AND EXPENSES OF 103 PERSONAL FINANCE LICENSEES IN NEW JERSEY, 1937, BY SIZE OF OFFICE[a]

Size of Office[b]	*Gross Earnings in % of Employed Assets*[b]	*Expenses in % of Gross Earnings*				*Net Return in % of Employed Assets*[b]	*% Distribution*	
		Total	Salaries	Bad Debts	All Other[c]		Number of Offices	Employed Assets[b]
$ 10,000– 25,000	16.7	150.9	91.8	...	59.1	−8.5	1.0	.1
25,000– 50,000	14.4	93.9	48.2	4.8	40.9	1.7	18.4	3.8
50,000– 75,000	18.9	89.7	44.6	7.1	38.0	1.9	12.6	4.5
75,000–100,000	17.5	88.7	41.6	4.9	42.2	2.0	8.7	4.2
100,000–200,000	22.5	66.8	26.3	6.8	33.7	7.4	27.2	23.0
200,000–300,000	23.7	62.4	24.4	5.4	32.6	9.2	13.6	18.7
300,000–400,000	27.4	52.6	18.4	4.2	30.0	10.2	10.7	20.2
Over $400,000	21.5	57.4	17.4	7.7	32.3	9.2	7.8	25.5
TOTAL	22.8	62.5	23.6	6.0	32.9	8.1	100.0	100.0

[a] Based on individual reports of small loan licensees in the New Jersey *Annual Report of Commissioner of Banking and Insurance* (1937) pp. 90–101. The total year-end employed assets of the 103 offices was $18,410,284.

[b] Total employed assets as of December 31st.

[c] Exclusive of interest.

TABLE 34

EARNINGS AND EXPENSES OF 358 PERSONAL FINANCE LICENSEES IN ILLINOIS, 1937, BY SIZE OF OFFICE[a]

Size of Office[b]	*Gross Earnings in % of Employed Assets*[b]	*Expenses in % of Gross Earnings*				*Net Return in % of Employed Assets*[b]	*% Distribution*	
		Total	Salaries	Bad Debts	All Other[c]		Number of Offices	Employed Assets[b]
Under $ 10,000	27.4	75.4	35.8	5.3	34.3	6.7	7.5	.4
10,000– 25,000	23.1	83.2	42.4	9.5	31.3	3.9	17.3	2.6
25,000– 50,000	26.1	77.3	39.7	9.8	27.8	5.9	18.2	5.4
50,000– 75,000	26.2	67.0	31.9	9.6	25.5	8.7	12.3	6.5
75,000–100,000	26.2	69.9	35.2	9.2	25.5	7.9	7.5	5.6
100,000–200,000	25.6	66.5	25.5	7.8	33.2	8.6	15.1	19.1
200,000–300,000	27.3	64.3	25.8	7.1	31.4	9.8	10.3	21.8
300,000–400,000	26.5	59.3	19.8	7.1	32.4	10.8	7.3	21.2
Over $400,000	31.3	65.1	28.7	6.8	29.6	10.9	3.1	17.0
Total single-office reports	27.2	65.4	27.1	7.6	30.7	9.4	98.6	99.6
Consolidated reports	35.5	73.4	40.0	6.8	26.6	9.4	1.4	.4
TOTAL	27.2	65.5	27.2	7.6	30.7	9.4	100.0	100.0

[a] Based on Illinois, Division of Small Loans, *Analysis of Reports Filed by Personal Finance Companies, 1937*, Schedule I, p. 16. The total year-end employed assets of the 358 offices was $41,350,573.
[b] Total employed assets as of December 31st.
[c] Exclusive of interest.

between the two states is apparently due to higher ratios of expense to gross earnings in New Jersey, primarily higher salary percentages. Possibly in New Jersey a larger proportion of offices of these sizes are independents and pay out earnings in the form of salaries to owner-managers rather than as profits to parent chain companies. Net return on total assets (and also the gross earnings percentage, with a single slight exception for $300,000-400,000 offices) is consistently lower in New Jersey than in Illinois, for offices of all sizes, though for offices of more than $100,000 assets the differential between the states is much reduced. In this connection it is significant to note that for $100,000-200,000 offices total expenses, and especially salaries, take only a slightly higher percentage of gross earnings in New Jersey than in Illinois, and that for offices of more than $200,000 assets they take a considerably lower proportion than in Illinois. Doubtless one reason for the consistency of the differential between the states in regard to net return is that lower legal rates obtain in New Jersey.

In view of the greater profitability of larger offices it is not surprising to find that they control a substantial share of the total business. In Illinois 36 percent of the offices had total assets of more than $100,000 and controlled 79 percent of all assets employed in the business. In New Jersey loan offices of this size constituted 59 percent of the total number and held 87 percent of total personal finance company assets.

Chain offices usually have upwards of $50,000 in employed assets and therefore they fall in the more profitable size groups, showing a higher ratio of net return to total employed assets than do any other types of offices except partnerships. Data for the various types of lenders in Indiana, given in Table 35, show that chain lenders have, on the whole, the largest offices and enjoy the highest ratio of gross earnings to total employed assets. Also they show a lower ratio of expenses to earnings than any other type except partnership offices.

TABLE 35

EARNINGS AND EXPENSES OF 274 PERSONAL FINANCE LICENSEES IN INDIANA, 1937, BY TYPE OF LICENSEE[a]

Type of Licensee	*Gross Earnings in % of Employed Assets*[b]	*Expenses in % of Gross Earnings*				*Net Return in % of Employed Assets*[b]	*% Distribution*		*Average Size of Office*[b]
		Total	Salaries	Bad Debts	All Other[c]		Number of Offices	Employed Assets[b]	
Independent individuals	25.2	77.5	42.9	9.4	25.2	5.7	11.3	3.2	$ 19,562
Partnerships	25.4	57.2	34.4	2.5	20.3	10.8	3.6	1.3	24,264
Independent corporations	22.1	72.2	33.1	11.9	27.2	6.1	28.1	18.4	45,400
Indiana chains	27.6	64.7	26.6	6.8	31.3	9.7	46.4	51.4	76,770
Outside chains	28.7	64.7	20.6	10.6	33.5	10.1	8.4	21.2	175,259
Affiliated companies	24.0	66.1	22.1	8.8	35.2	8.1	2.2	4.5	143,901
TOTAL	26.5	66.1	26.6	8.5	31.0	9.0	100.0	100.0	69,303

[a] Based on Indiana, Department of Financial Institutions, *Annual Report, July 1, 1937, to June 30, 1938*, pp. 139–40. The figures refer only to loan operations in Indiana; the total year-end employed assets of the 274 licensees was $18,988,998.
[b] Total employed assets as of December 31st.
[c] Exclusive of interest.

The latter, next to the smallest in average size, have the lowest ratio of expenses and the highest net return on employed assets.

As to the individual expense items, the ratio of salaries to gross earnings is highest for independent lenders, and successively lower for partnerships, independent corporations, local Indiana chains and outside chains. The bad-debt loss percentage shows wide variation; it is lowest for partnerships and highest for independent corporations and outside chains. Other expenses, combined, show a substantially higher percentage for chain and affiliated companies than for the other types.

In considering these figures it should be borne in mind that there are considerable differences in accounting practices, and that therefore the data for the various types of licensees are not rigidly comparable. Also certain specific circumstances undoubtedly affect the data in each case. For example, the notably high net return percentage of partnerships seems to result largely from their notably low bad-debt percentage, and this in turn may be due to specific policies or practices not statistically measurable, rather than to the organizational structure of the licensees, for only a handful of lenders come under this classification. And again, the higher salary percentage and the low net return percentage of independent individual lenders are undoubtedly due partly to the fact that earnings are paid out to owner-managers directly as salaries rather than being retained in the business and distributed periodically as profits. The comparatively favorable position of the chain companies is probably a justified deduction, however, especially in view of the corroborative evidence from the analysis of office size.

6

Rates of Charge

IN THE rates charged on personal small loans the consumer's interest focuses on the cost of money borrowed, the lender's on the relation of rates to profitability, that is, on the income from loans of different sizes and types compared with the average loan expense. The ultimate cost to the borrower is ordinarily simple to determine when the charge is expressed as a percent of unpaid balance for a stated period of time, but it may be difficult to analyze when charges are differentiated by type of loan and are presented in a complicated system of rate quotations. For the lender the relation between rates and profitability may also be difficult to determine exactly, because the cost of making loans may decrease as more loans are made. It is important, however, to analyze personal finance company rates from these two viewpoints. Therefore in this chapter we examine the cost to consumers, both in dollar and in percentage terms, of loans of various sizes and durations under different rate systems, and also the contention made by some representatives of the business that loans of smaller amounts entail higher costs than larger loans and consequently justify higher rates of charge.

FORMS OF RATE QUOTATION

The maximum lawful rates chargeable by small loan licensees in various states were presented in Table 2 (p. 34). These rates may be classified into several general types.[1]

[1] The word "rate" is here used to designate a specific formula from which monthly charges are computed. Unless otherwise qualified it signifies an average or representative monthly percent of charge on unpaid balance.

The first of these may be called the "flat" rate, a straight monthly percentage of the unpaid balance; this form of quotation was specified in the original draft of the Uniform Small Loan Law and remained the general type of rate until about 1932. It is now in effect in 13 states and the District of Columbia. Originally it was considered the ideal method of charge, and certainly it has two great advantages: it is simple to apply and easy to understand.

The second general type of rate, which has recently become popular and is tending to supplant the flat type, is the combination rate; this combines two or more rates, allowing for a higher rate on an unpaid balance up to a specified figure and a lower rate on the remainder of the balance. The latest draft of the Uniform Small Loan Law[2] recommends, as an experimental maximum, 3½ percent a month on an unpaid balance up to $100 and 2½ percent on the remainder. At present 14 states and Hawaii have adopted maximum rates of the combination type.[3]

A special form of the combination rate which might lead to confusion is one which provides for a decreasing rate of charge computed on unpaid balance but graduated according to the original size of the loan, for example, 3 percent a month on loans of $100 or less and 2½ percent on loans of more than $100. Such a rate, graduated according to size of loan, is at present employed only in Missouri. A borrower might easily confuse the two types of charges and regard a rate of "3-2½ percent graduated at $100" as one with a charge of 2½ percent on all loans above $100, whereas it is actually a 2½ percent charge on that part of the unpaid balance above $100. When the rate is graduated according to size of original loan the loans above the dividing line carry a lower rate throughout their duration than do the loans of smaller

[2] The sixth draft, published January 1, 1935.
[3] Table 2 shows 15 states with graduated, or combination, maximum rates of charge. It includes Missouri, however, which is here classified separately.

amount; therefore borrowers may pay different charges on identical balances if originally they had borrowed different sums. The total difference in charge between loans just above and just below the dividing line is not insignificant; under the 3-2½ percent rate, for example, the initial monthly charge would be $3 on a loan of $100, and $2.75 on one of $110.

There is another type of rate, not now in general use, which is referred to in the trade as the "restatement" rate. It provides for a regular interest charge and, in addition, for stipulated fees to recompense the lender for various services rendered. A schedule of this kind has recently been advocated by Jackson R. Collins as a means of circumventing provisions of certain state constitutions regarding legal interest.[4] It would require for each loan an investigation fee amounting to a maximum of 5 percent of the face of the note, but not exceeding $15, and an interest charge of 5 percent per year, both to be deducted in advance from the amount borrowed. Rebates of unearned interest would be allowed if the loan were paid off in full before maturity. There would also be a maximum monthly service fee, graduated according to the size of the loan, as follows: $1 on loans over $75, 75 cents on loans from $51 to $75 inclusive, 50 cents on loans from $26 to $50 inclusive, and 25 cents on loans not exceeding $25. While no rates so complex as that proposed by Collins are to be found in Table 2, there are a few rates that approximate this type. In Colorado, for example, there is an interest

[4] In a few states, including Arkansas, Oklahoma, Tennessee and Texas, the maximum legal interest rate is constitutionally determined and cannot be altered by legislative action; a legal small loan business apparently cannot be successfully conducted under the constitutional rate, but the additional fees proposed in the Collins plan would presumably permit of profitable operation. It is Collins' thesis that a fee for investigation and a monthly service charge represent payment for services rendered by the lender, not interest as such for the use of funds borrowed, and that the courts will generally permit the collection of special fees in addition to the maximum legal rate of interest. See *Report on Conference on Personal Finance Law*, Kansas City, September 28, 1937.

charge of 10 percent per year plus an investigation fee of one-tenth the amount of the note.

CHARGES TO CUSTOMERS UNDER VARIOUS TYPICAL RATES

The maximum legal rates shown in Table 2 are not identical with the rates actually in effect, for any licensee is permitted to charge less than the maximum rate. Thus in a state where the maximum legal charge is a flat 3½ percent per month on the unpaid balance, a licensee could, if he wished, charge 3 percent per month, or 3½ percent on unpaid balance up to $100 and 2 percent on the remainder, or 3½ percent per month with a maximum charge of $5, or any of many other rates which might be mentioned. Any rate would be permissible as long as no borrower was charged more than 3½ percent on any portion of his unpaid balance.

It is not possible, and probably could serve no purpose, to present a compendium of all the different rates which are in effect throughout the United States. Instead we present a list of some of the more common rates, the most important of which are naturally the legal maxima in the various states. A schedule of total dollar charges under these selected rates, for various loan sizes and loan periods, is presented in Table 36, the charges being computed on the assumption that the loan is amortized by a fixed capital repayment each month. Table 36 shows also, for the various rates, the average monthly percentage charge for a loan of $300 repaid in 12 months, computed by dividing the total actual dollar charge by the sum of the monthly balances outstanding.

The various rates shown in this table are arranged in order of magnitude, high to low, according to the total dollar charges on a 12-month loan of $200. It is interesting to note that in most cases the rates on loans of other denominations and other durations conform with this ranking; thus the table

allows of certain conclusions as to which rates are relatively higher than others. But rates should be compared only as they relate to particular circumstances. A borrower, if given the opportunity of choosing among alternative rates, would make his choice to fit his own particular case. He needs a certain amount of money, which he can repay in so many months, and perhaps he will need a second loan before he pays out completely. These and perhaps other considerations have to be borne in mind in choosing the best available rate.[5]

The comparison of rates is made more difficult by the fact that there is more than one method of expressing them. Rates may be expressed as total dollar charges, as in Table 36; but they may also be expressed as an average monthly rate of charge, determined by one of several methods, all of which give approximately but not precisely equal results. In most cases, however, it makes no difference which criterion is used. Whether the borrower compares alternative rates by determining an average effective interest rate or whether he uses the much simpler expedient of merely computing the total charges he will have to face, he will usually arrive at the same conclusion.

A question frequently asked concerns the per annum equivalent of monthly small loan rates. When there is a flat percentage charge the annual rate is of course just twelve times the monthly rate. A fixed percentage charge of 3½ percent per month, for example, means that the borrower pays

[5] A single example will serve to show some of the various factors and complexities encountered in the choice of the most favorable rate. If a person has the choice of borrowing $300 at a straight 2½ percent or at a 3-2 percent rate graduated at $100, and if he expects to pay this loan off in 12 or 20 monthly instalments, he would choose the 2½ percent rate, for his charges are then less (see Table 36). But there are circumstances in which the 2½ percent rate would be more costly. Suppose that the borrower agrees to repay the $300 in 12 months; that after making six payments aggregating $150 he encounters some misfortune necessitating reborrowing $150, so that he again owes $300 to be repaid in 12 months, and that after making six more payments he has a windfall which enables him to repay the entire balance, $150, at once. With the straight 2½ percent loan the total interest charge would be $78.75, but with the graduated rate it would be $77.

TABLE 36

TYPICAL RATE SCHEDULES ON PERSONAL FINANCE COMPANY LOANS, CORRESPONDING TOTAL DOLLAR CHARGES ON REGULARLY AMORTIZED LOANS OF VARYING SIZE AND DURATION, AND AVERAGE MONTHLY PERCENTAGE RATE ON $300 LOAN REPAID IN 12 MONTHS

Rate Schedule	TOTAL DOLLAR CHARGE BY SIZE AND DURATION OF LOAN							*Average Monthly Rate on $300 Repaid in 12 Months*[a]	*States in Which Rate Is Legal Maximum*
	$50	*$100*		*$200*		*$300*			
	10 Mo.	12 Mo.	20 Mo.	12 Mo.	20 Mo.	12 Mo.	20 Mo.		
5/6% + fee[b]	$.....	$23.14	$.....	$46.28	$.....	$69.42	$.....	3.55%	Colo., Neb., N. M.
3½% flat	9.63	22.75	36.75	45.50	73.50	68.25	110.25	3.50	Ariz., Fla., La., Md., Va.
3½–2½% at $150	9.63	22.75	36.75	44.50	72.00	63.00	101.91	3.23	Ky., W. Va.
3½–2½% at $100	9.63	22.75	36.75	42.00	68.00	59.25	95.91	3.04	Hawaii
3% flat	8.25	19.50	31.50	39.00	63.00	58.50	94.50	3.00	Minn., Ohio,[c] Ore.,[d] R. I., Utah
3–2½% at $150	8.25	19.50	31.50	38.50	62.25	55.88	90.38	2.86	Ill., Me.,[e] N. Y.
3–2% at $150	8.25	19.50	31.50	38.00	61.50	53.25	86.25	2.73	Ia., Mass., Pa.[f]
3–1½% at $150	8.25	19.50	31.50	37.50	60.75	50.63	82.13	2.60	Ind.[g]
3–2½% at $100	8.25	19.50	31.50	37.25	60.25	54.00	87.33	2.77	Mich.
3–2% at $100	8.25	19.50	31.50	35.50	57.50	49.50	80.15	2.54	Conn.
3–2–1% at $100 & $200	8.25	19.50	31.50	35.50	57.50	47.00	76.30	2.41	None
Collins Rate[b]	10.56	23.11	.....	34.22	.....	43.67	.....	2.24	None
3–2½% at $100[h]	8.25	19.50	31.50	32.50	52.50	48.75	78.75	2.50	Mo.
2½% flat	6.88	16.25	26.25	32.50	52.50	48.75	78.75	2.50	N. J.
2½–2¼% at $125	6.88	16.25	26.25	32.01	51.70	47.00	75.98	2.41	Vt.
2½–2% at $100	6.88	16.25	26.25	30.75	49.75	44.25	71.58	2.27	Calif.
2½–2–1% at $100 & $200	6.88	16.25	26.25	30.75	49.75	41.75	67.73	2.14	Wisc.
2% + fee[i]	7.50	15.00	23.00	28.00	44.00	41.00	65.00	2.10	N. H.
2% flat (no fee)	5.50	13.00	21.00	26.00	42.00	39.00	63.00	2.00	None
1½% flat	4.13	9.75	15.75	19.50	31.50	29.25	47.25	1.50	Ga.

annual charges equal to 42 percent of his average outstanding balance; it means further that a small loan company will receive a gross income of approximately 42 percent per year of its loan volume employed in the business, provided it collects 100 percent of its charges on the due date.[6]

The per annum equivalent of combination rates is not so obvious and may be determined only for loans of given size and duration. It may be approximated, however, from the figures in Table 36: a rate of 3½-2½ percent graduated at $100, for example, is lower than (or the same as) a 3½ percent and higher than a 3 percent straight rate for all regularly amortized loans, and therefore the per annum rate on such loans is somewhere between 36 and 42 percent. Since the

[6] It has been alleged that since interest on small loans is paid monthly there is a possibility of monthly compounding and that therefore a rate of 3½ percent a month is not 42 percent a year but 51 percent. This, however, is not very reasonable. If the personal finance company could reinvest each month 100 percent of its gross earnings, representing 100 percent collections on employed assets, it would indeed show a return of 51 percent per year on the capital invested at the beginning of the year; but no personal finance company can operate on these terms. Again, lenders are usually forbidden by law to add interest charges to principal in case of default. They can, of course, plough back each month any excess earnings that are not needed to pay expenses or meet dividend payments; but the portion of monthly receipts that may be so utilized is small; and, in practice, monthly receipts amount to substantially less than the 3½ percent of assets which is theoretically to be expected.

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[a] Computed by dividing the total dollar charges by the sum of the monthly balances outstanding—equivalent to dividing the total dollar charges by the product of number of months outstanding and the average balance outstanding.
[b] A 10 percent discounted service charge renewable semi-yearly in addition to the 10 percent per year interest. This rate and the proposed Collins rate are not directly comparable with the other rates shown in the table. In both cases the quoted charges should be considered as only approximations; they are based on the actual amount of cash advanced to the borrower, not on the face amount of the note. For a description of the Collins rate see p. 123.
[c] In Ohio there is an additional charge of $1 on loans of $50 and less.
[d] In Oregon there is a minimum charge of $1 per month on secured loans.
[e] In Maine there is a minimum charge of 25 cents per month.
[f] In Pennsylvania there is a rate of 6 percent per year on balances outstanding after 18 months.
[g] In Indiana there is an additional fee of 50 cents on certain loans.
[h] Note that rate is graduated according to original amount of loan rather than according to unpaid balance.
[i] A fee of $1 on loans of $50 or less, and $2 on loans over $50.

rates on individual loans vary considerably, there is no justification for attempting to obtain a more precise figure for the per annum rate.

THE RELATIONSHIP BETWEEN RATES AND LENDERS' COSTS

There has been much controversy among small loan experts on the ideal form of rate schedule. The Russell Sage Foundation and many others originally favored the flat percentage rate because of its simplicity. Others have held that the flat rate charge is unfair, since two classes of customers, the borrower of very small amounts and the borrower who repays his loan long before contractual maturity, do not pay enough to meet the costs of extending them service, and that therefore the flat rate should be replaced by one whereby each class of borrowers pays the actual costs incurred in extending the service received.

In view of this controversy it is surprising that there is no adequate information available on the actual costs of making loans of various sizes and durations. The few cost accounting studies that have been made are not sufficiently detailed for the purpose. One available study, made by the Household Finance Corporation, is based on the operations of 8 New Jersey offices over eight months of 1931.[7] Although the company has since abandoned this method of analysis we present it here as one possible approach to the problem of determining relative costs by size and duration of loan.

The Household computation involved three steps. First, the cost of making loans, including all expense that could directly or indirectly be allocated to investigation and to opening and closing the account, was divided by the total number of loans made during the period; this resulted in a cost per loan of $5.1688, hereafter called investigation cost, and

[7] Brief submitted by the Household Finance Corporation to the New Jersey Small Loan Commission, November 23, 1931, pp. 5 ff.

dividing by 12.35, the average number of months during which all loans were outstanding, gave $.4185 as the average investigation cost per loan per month. Second, a carrying cost was determined by dividing the total cost per month of carrying and collecting all loans by the average number of loans on the books at the beginning of each month; in this way $.9071 was obtained as the average cost per month of carrying a loan. Third, a percentage capital cost was computed by totaling bad debts and similar losses, federal income taxes, and a profit allowance at the rate of 12 percent of the amount of capital funds employed, and dividing this sum by the amount of capital employed; as a result, 1.5061 percent per month of the average outstanding balance was found to be the cost of providing capital.

TABLE 37

AVERAGE COST PER MONTH OF MAKING AND OF CARRYING A PERSONAL FINANCE COMPANY LOAN, JANUARY–AUGUST 1931, BY SIZE OF LOAN[a]

Size of Loan	*Operating Cost per Month*[b]	*Capital Cost per Month*[c]	*Total Cost per Month*	*Necessary Rate Charge per Month*	*Average Balance Outstanding During Life of Loan*[d]
$ 30	$ 1.3256	$ .3021	$ 1.6277	8.11%	$ 20.06
50	1.3256	.5035	1.8291	5.47	33.43
100	1.3256	1.0071	2.3327	3.49	66.87
200	1.3256	2.0142	3.3398	2.50	133.74
300	1.3256	3.0214	4.3470	2.17	200.61

[a] Based on brief submitted by the Household Finance Corporation to the New Jersey Small Loan Commission, November 23, 1931, p. 6; the data cover the operations of 8 New Jersey offices of this company. The duration of the loans is assumed to be 12.35 months, which is the average for all loans during this period.

[b] Investigation cost of $.4185 plus carrying cost of $.9071, irrespective of size.

[c] Amounting to 1.5061 percent of average balance outstanding.

[d] These figures computed from a sample of loans of all sizes paid off during the period; the sample probably includes loans that were renewed before being paid off.

In this threefold classification of costs the investigation cost is independent of the size and duration of the loan; the cost for the expenses of carrying and collecting is independent of the size of the loan; and the capital cost varies directly with the amount of the outstanding balance. On the basis of such a threefold classification it would be possible to estimate the cost of making a loan of any size and any duration. In the study carried out by the Household Finance Corporation, however, computations were made for loans of various sizes but of only one duration, 12.35 months—the average for all loans during the period specified. The results of this study, as they apply to loans of several sizes, are presented in Table 37, which also indicates the necessary rate charge per month to cover these costs.

Jackson R. Collins[8] recently reported a study comparable to that of the Household Finance Corporation. The results are summarized in Table 38, with average annual cost itemized in four categories, for the period 1929-36. It is interesting to note that credit investigation and acquisition expense, plus expenses incidental to closing transactions, is here $6.77 per year, as compared with the Household estimate of $5.17. The difference may be explained partially by the fact that Household had no advertising expense in New Jersey in 1931. The Collins estimate of average carrying cost of $10.49 per year, or $.87 per month, is almost identical with Household's $.91 per month. In the Collins study the item for bad debts is strictly a variable cost that should properly have been combined with the total costs of providing capital, and the lack of any treatment of capital costs is a decided shortcoming.

According to these estimates a rate schedule which would insure that each loan pay its share of costs should include: a fee of about $7, regardless of the size or duration of the

[8] *Report on Conference on Personal Finance Law,* Kansas City, September 28, 1937.

TABLE 38

AVERAGE COST PER YEAR OF MAKING AND OF CARRYING A PERSONAL FINANCE COMPANY LOAN, 1929–36[a]

Item	*Cost*
Credit investigation and acquisition expense	$ 5.77
Expenses incidental to closing transactions	1.00
Bad debts charged off	3.38
Carrying charges	10.49
TOTAL	20.64

[a] Based on J. R. Collins, *Report on Conference on Personal Finance Law*, Kansas City, September 28, 1937, p. 30. Each figure represents an unweighted average of annual averages.

loan, to cover the costs of opening and closing the account; a monthly service fee of about $1, regardless of the amount of the unpaid balance; and an interest fee of about 1½ percent per month on the unpaid balance. Such a rate is somewhat similar in form to the restatement rate discussed above.[9] The restatement rate, however, would provide for an investigation fee graduated according to size of loan, and for an annual rather than a monthly interest charge.

Such divisions of costs serve to show why the lender often considers very small loans, or loans repaid in a month or so, to be unprofitable under the flat-rate method of charging; but as a meaningful treatment of costs they have definite shortcomings. Some costs cannot be allocated to any of these categories, but must be charged against the general conduct of the business; such costs are license fees, and probably managers' salaries, auditing, at least part of rent and part of advertising, and it is probable that these are by no means negligible. If such general costs are to be fitted into a threefold, or a fourfold, classification, they must be allocated by some arbitrary method. They might be divided equally among all loans regardless of size; they might be apportioned

[9] See p. 123.

according to size; or they might be distributed according to loan duration, as so much general cost per month. In fact, any arbitrary cost accounting basis might be used, or even some preconceived standard of social justice.

Moreover, even if it were possible to classify all costs according to four categories—investigation, carrying, capital and general—such concepts as average investigation cost per loan made, average carrying cost per loan carried, and average capital cost per month per dollar outstanding, are somewhat misleading. These per-unit costs may vary with size or duration of loan, size of the establishment, type of borrower or nature of the security.

With regard to size of loan, it has already been shown that, other things being equal, charge-off losses are relatively higher for large loans than for small loans;[10] this would seem to necessitate a more exhaustive investigation of the borrowers of large amounts, or else the setting up of more than proportional reserves against losses from this source. In either case the larger loan is relatively more costly on this account than the small loan.

It is difficult to generalize about the variation of unit loan costs among offices of different sizes. We have already presented evidence showing that the net rate of return increases as size of office increases;[11] one would naturally conclude from this that unit costs are less for the larger offices.

Similarly, it cannot be assumed that the cost of investigation is as great for present and former borrowers as it is for new borrowers; and also other items of cost, particularly risk, may be expected to vary among old, present and new customers. Moreover, a loan secured by a chattel mortgage on household goods, on which it is necessary for an "outside" man to investigate the home, is doubtless a more costly undertaking than a schoolteacher loan, an unsecured or note loan,

[10] See Table 29, p. 104.
[11] See Tables 33 and 34, pp. 116-17.

or a wage-assignment loan, for which the nature of the credit investigation is quite different.

The main significance of such studies of loan costs as those reviewed here is that they distinguish the principal cost components. As guides to operations in the business they may be quite misleading. The estimates of cost that have been presented are estimates of average costs, computed by distributing the total of a particular kind of cost equally among all loans made. But in attempting to achieve maximum efficiency the loan office manager must consider much more than these average costs. If his facilities are not fully utilized additional business may be handled for a very small additional expense, and he may profitably take on loans of a type that might be considered unprofitable at existing rates if average costs were the only criterion. In particular, he might be glad to make loans of less than average size, or loans of shorter than average length, even though he could show that such business did not pay enough to cover the average cost, for the average cost might be reduced by the additional volume of business.

These considerations merely suggest that the criterion of average cost as the basis for discriminating in charges as between smaller and larger loans, or shorter or longer note lengths, is subject to many difficulties from the standpoint of actual lending operations. The employment of average costs for such purposes ignores too the social and regulative aspects of personal loan charges, but with these the present study has not been directly concerned.

7

The Effects of Changes in Maximum Legal Rates

THE legal rates of charge permitted licensed personal finance lenders are frequently criticized as excessive. Lenders, however, defend these rates on the ground that costs of small loan retailing are high and necessitate legal rates sufficiently large to encourage licensed operation. Otherwise, they contend, the business will either disappear entirely, cutting off these credit facilities from the low income groups normally constituting the market for personal finance loans, or it will be conducted illegally at still higher rates of charge by persons willing to risk prosecution under the usury statutes. To support this contention of licensed lenders the experiences of states that have drastically changed the maximum rate provisions of their small loan laws—from levels in some cases regarded by licensed lenders as adequate, in some cases as inadequate—are often cited.

For a factual analysis of the result of rate changes it would be desirable to have annual data for each state on at least the following bases of comparison: the number of licensees; the number of loans made; the average size of loan made; the volume of loans outstanding; and the average size of loan office as measured by loans outstanding. Only part of this material is available, and therefore an analysis of the effect on the personal finance business of changes in maximum legal rates must be confined to 5 states for which there is sufficient information: New Jersey, West Virginia, Georgia, Tennessee and Missouri. In New Jersey and West Virginia the maxi-

mum legal rate was reduced and subsequently raised; in Georgia, Tennessee and Missouri rates were reduced and continued without further change.[1] In the following pages the changes in these states are discussed in order of severity.

RATE CHANGES IN NEW JERSEY

On May 6, 1929, effective February 15, 1930, a law reducing the maximum legal rate from 3 to 1½ percent per month on unpaid principal balances was passed in New Jersey. The legal maximum was raised again in 1932, and therefore it is the situation existing from 1929 to 1931 that is significant in studying the effects of reductions in legal rates.

Almost immediately after the legislative rate reduction became effective small loan licensees began to liquidate their businesses. This is apparent from Table 39, which shows that between 1929 and 1931 the number of licensed lenders declined from 415 to 117, and outstanding loan balances fell from approximately $20,500,000 to less than $5,500,000. There was a substantial increase in the size of loans made during these years, the average rising from $165 in 1928 to $240 in 1931, a change appearing particularly significant when it is recalled that the maximum legal loan for such lenders was $300. It is interesting to observe, however, that in comparison with changes occurring later, rate reduction had very little effect on the average size of loan office.

Some indication of the degree to which these developments may be attributed to the reduction in the maximum legal rate is obtained by comparing New Jersey experience with the small loan business of the country as a whole, and especially with experience in Massachusetts, where the economic structure of the state is reasonably similar to that of New Jersey but where legal rates remained unchanged. In 1929-31, while outstanding loans in New Jersey were falling off by

[1] In Missouri a new rate went into effect on November 1, 1939.

TABLE 39

NUMBER OF PERSONAL FINANCE LICENSEES, VOLUME OF LOAN BALANCES OUTSTANDING, AND AVERAGE SIZE OF LOAN, NEW JERSEY AND MASSACHUSETTS, 1928–36[a]

Year	NEW JERSEY				MASSACHUSETTS[b]			
	Number of Licensees	*Loans Outstanding*[c]		*Average Loan*[d]	*Number of Licensees*	*Loans Outstanding*[c]		*Average Loan*[d]
		Total	Average per Office			Total	Average per Office	
1928	437	$19,001,000	$ 43,500	$165	106	$ 5,248,000	$49,800	$124
1929	415	20,549,000	49,500	...	137	9,198,000	67,000	150
1930	183	7,948,000	43,400	...	162	12,200,000[e]	75,000[e]	152
1931	117	5,400,000	54,700	240	193	14,557,000	75,500	150
1932	83	6,252,000	75,300	...	204	14,285,000	69,900	145
1933	83	7,730,000	93,100	167	192	13,755,000	71,600	137
1934	82	9,461,000	115,500	176	184	15,274,000	83,000	137
1935	87	10,478,000	132,000	168	184	15,907,000	86,400	138
1936	97	13,474,000	139,000	163	184	16,844,000	91,500	141

[a] Based on annual reports of state banking department of New Jersey and of Massachusetts Bureau of Loan Agencies.
[b] Data include chartered companies and licensed lenders but not Morris Plan banks.
[c] As of December 31st. The average volume per office has been computed by dividing the total volume by the number of licensees.
[d] Based on accountants' reports prepared for the state association of personal finance companies from data filed with the state banking department.
[e] Estimated.

nearly 75 percent, the estimated total of personal finance company receivables throughout the nation increased from $255,500,000 to $285,600,000.[2] In Massachusetts, as is evident in Table 39, the number of licensed lenders increased during these years from 137 to 193, and loans outstanding rose from $9,200,000 to $14,600,000. Furthermore, while the average New Jersey loan increased significantly in size, the average Massachusetts loan remained about constant.

These data seem to indicate that general economic conditions do not explain the changes in number of licensed lenders, in total volume of loans outstanding, and in average size of loan made, that occurred in New Jersey between 1929 and 1931. In fact, it can be inferred with fair certainty that the 50 percent reduction in the maximum legal interest rate forced many New Jersey lenders out of business and encouraged those who remained to restrict their activities principally to the market for larger loans. Some lenders moved out of the state in search of more favorable lending conditions. An extract from a report of the Pennsylvania state banking department states: "Many of the organizations licensed to do business in New Jersey prior to 1929 removed their offices to Morrisville, Pennsylvania, which is just across the Delaware from New Jersey's capital, Trenton, and to Philadelphia, where on the other side of the Delaware are Camden and many other smaller cities and towns in South Jersey. New Jersey borrowers came from points within a radius of fifty miles to obtain loans from Pennsylvania offices at 3½ percent per month for the reason that there were no facilities in New Jersey where these loans could be obtained at the legal rate of 1½ percent per month."[3]

The Household Finance Corporation has made a report on its operations in New Jersey during the reduced-rate

[2] M. R. Neifeld, *Personal Finance Comes of Age* (1939) p. 14.
[3] Pennsylvania Banking Department, *Report on Small Loan Companies* (February 1937, as per House Resolution No. 180, adopted June 21, 1935) p. 12.

period.[4] This company, although fearing that the new low rates would preclude profitable operation, continued several offices on an experimental basis and found that liquidation of many lending concerns had almost eliminated competition. In consequence the company was in a position to effect numerous economies; it ceased to advertise and operated only offices of about $300,000 in assets because this size was considered most efficient. In spite of the cessation of advertising, applications for loans were so numerous that the company was able to exercise the greatest discrimination in selecting risks and to confine loans to the most profitable size —$200 to $300. By this means it remained possible to operate loan offices at a small profit, the Household Finance Corporation reporting: "While restricting service to the more profitable sizes and better risks, with practically no competition, the corporation was able to earn only 4.40 percent on employed capital, and would have operated at a loss under normal competitive conditions."[5]

The New Jersey small loan law was amended in 1932 to permit a maximum rate of 2½ percent per month on unpaid principal balances, and further indication of the effect of changes in legal rates is given by New Jersey experience between 1932 and 1936 (Table 39). After this amendment the volume of loans outstanding increased from $6,300,000 in 1932 to $13,500,000 in 1936. The average loan fell in 1933 to $167, almost identical with the average loan under the 3 percent maximum rate allowed in 1928. In Massachusetts, on the other hand, where the legal rate was not changed, the volume of loans outstanding and the average size of loan remained fairly constant during this period. It would appear, then, that if other factors are unchanged a rise of this magnitude in the maximum legal rate will tend to increase the

[4] Brief submitted by the Household Finance Corporation to the New Jersey Small Loan Commission, November 23, 1931.
[5] *Ibid.*, p. 1.

volume of loans outstanding and decrease the average size of loan, and vice versa.

One of the most interesting features of the New Jersey experience between 1932 and 1936 is that the increase in maximum legal rate did not cause lenders who had left the field in 1929 to return, nor did it seem to attract new licensed lenders into the small loan business. In consequence the average size of loan office in New Jersey rose rapidly between 1932 and 1936, a tendency found also in Massachusetts, but on a much smaller scale. This development necessitates consideration of certain additional features of the 1932 New Jersey small loan law.

The law included provisions that: (a) a small loan company cannot be granted a license unless it has $25,000 of net worth and $25,000 in liquid assets either invested in small loans or available for such investment; (b) the granting of a license must "promote the convenience and advantage of the community"; (c) the fee for a license should be $200 and all applicants for licenses must pay an additional $50 investigation fee.[6]

Provision (a) was a new departure in New Jersey law, and doubtless explains to some extent the increased size of loan office after 1932.[7] The average size of loan office in 1930 was less than $45,000, and therefore many offices operating at that time could not have met the new requirements of the 1932 law. Provision (b) was, presumably, a device to limit the number of offices in the community in accordance with competitive conditions and, to judge by the marked change in average size of office, must have been so interpreted and administered. Provision (c) was, of course, an added burden on the small office, but would not in itself have kept down

[6] New Jersey Laws of 1932, Chapter 62, Act passed April 12, 1932.

[7] The Commissioner of Banking and Insurance reported in 1932 that "thirty-eight licensees surrendered their licenses because of inability to meet the financial and other requirements of the new Act" (quoted in *Annual Report of the Commissioner of Banking and Insurance*, 1936, p. xxxix).

the number of licensees to the low figure that actually obtained. It seems evident that all of these changes in legal provisions, and not merely the change in maximum rate, had a bearing on the special character of New Jersey experience between 1932 and 1936.

RATE CHANGES IN WEST VIRGINIA

West Virginia's first small loan statute was enacted in 1925, and set the maximum rate at 3½ percent per month on unpaid principal balances. Early in 1929 this law was amended, the change effective in June, to reduce the maximum rate to 2 percent per month on unpaid principal balances. About four years later a second change was enacted: the maximum rate was raised to 3½-2½ percent, graduated at $150, by a law passed on March 11, 1933, effective 90 days from passage. Thus West Virginia provides for consideration a period from 1929 to 1933 during which a reduction was in effect, and the period since 1933, during which the rate has been higher again.

Table 40 shows that between June 30, 1929, and June 30, 1933, the total number of small loan licensees, as reported by the state banking department, fell by about two-thirds, from 62 to 23. Loan balances outstanding were reduced from over $1,500,000 at the end of 1929 to roughly $600,000 at the end of 1932, or nearly 60 percent, but by December 31, 1933, they had increased by more than 100 percent over the 1932 figure. This 1933 increase may have occurred before or after the rate change of June 9, 1933, or may have been spread throughout the year; in the absence of complete data it cannot be entirely explained in terms of rate change. The average size of loan office, as measured by loans outstanding, rose in 1930 by about 20 percent but fell in 1931 and continued to fall in 1932, apparently as the result, at least in part, of certain large lenders ceasing to do business in the state. For

TABLE 40

NUMBER OF PERSONAL FINANCE LICENSEES AND VOLUME OF LOAN BALANCES OUTSTANDING, WEST VIRGINIA, 1929–38

Year	Number of Licensees[a]	Loans Outstanding	
		Total[b]	Average per Office
1929	62	$1,540,000	$ 24,838
1930	36	1,080,000	30,000
1931	31	650,000	20,967
1932	32	640,000	20,000
1933	23	1,334,000	58,000
1934	32	2,029,832	63,432
1935	34	2,680,373	78,834
1936	34	3,452,769	101,552
1937	34	4,558,140	134,062
1938	41	4,551,925	111,022

[a] Based on state banking department figures, as of June 30th.
[b] Figures for 1929 through 1933, as of December 31st, are taken from M. R. Neifeld, *Personal Finance Comes of Age* (1939) p. 262. Figures for 1934 through 1938, as of June 30th, are taken from reports of the state banking department.

example, the Beneficial Industrial Loan Corporation was operating 7 offices in the state on June 29, 1929, but these offices ceased to do business in 1930 because a 2 percent rate was found unprofitable. Like the total volume of loans outstanding the average volume per office rose very sharply in 1933.

There is some indication that in West Virginia the reduction in the maximum legal rate encouraged illegal lending; the Better Business Bureau of Huntington, West Virginia, reported in 1931 that the rate change had "virtually forced the legitimate lenders out of business and served as an invitation to the high rate operators."[8]

[8] Quoted in the Pennsylvania report, *op. cit.*, p. 12. In view of the fact that there were 32 licensees in business in 1932, when the rate reduction was still in effect, the Bureau's report that legitimate lenders had been virtually forced out of business seems to be somewhat of an overstatement, even if many of these were in a state of liquidation.

On June 9, 1933, the amendment to the small loan law of 1929 became effective. In addition to raising the maximum legal rate to 3½-2½ percent, graduated at $150, the 1933 act requires that licensees pay an investigation fee of $50 and an annual fee of $100, besides bearing the expense of an annual examination, that the banking department grant new licenses only if such action "promotes the convenience and advantage of the community in which the business of the applicant is to be conducted," and that each licensee must have a minimum amount of liquid assets equal to $2000.

In 1934 the number of reported licensees rose sharply and it then remained fairly constant until 1938, when a further increase occurred. Aggregate loan balances outstanding increased greatly during 1933 and 1934, and continued to rise in subsequent years; in 1938 total loans outstanding were over seven times as great as in 1932 and over twice as great as the 1934 figure. The average loan balance outstanding per office rose greatly in 1933 and in 1938 it was nearly double the 1933 figure. This rise was doubtless due both to the increase in the total loan volume, following the rate increase, and to the state banking department's limitation of licensees.

In short, after the legal maximum rate was cut in West Virginia, the total number of licensees fell 63 percent within four years, whereas in the country as a whole the reduction in this period (1929-33) was only 5.5 percent.[9] Loan balances outstanding declined by 58 percent (1929-32), but for the country as a whole there was practically no decrease.[10] In 1933 the law was changed. Subsequently the total number of reported licensees increased by 28 percent (1934-38) while the national increase was only 10 percent. Loans outstanding increased by 70 percent (1934-36) while the increase for the country as a whole was 24 percent.[11]

[9] According to the number of licensees reported by the American Association of Personal Finance Companies.
[10] Neifeld, *op. cit.*, p. 14.
[11] *Ibid.*

In the absence of supplementary data it is not possible to say with certainty that the changes which took place in the personal finance business in West Virginia over the period 1929-38 arose solely from legal action, but these changes tend further to demonstrate that reductions in the maximum legal rate are followed by reductions in both loan volume and number of licensed lenders, and that rate increases are followed by increases in loan volume and number of lenders.

RATE CHANGES IN GEORGIA

On March 26, 1935, Georgia reduced the maximum rate chargeable under its small loan statute from 3½ to 1½ percent per month on unpaid principal balances, and has since continued this rate without change. As shown in Table 41, the number of licensees reported by the state banking department declined precipitately until, in 1937, only 8 remained. Loans declined to such an extent that by 1936, the last year for which data are available, they were only 13.5 percent of 1934 outstandings. It is interesting to note also that the aver-

TABLE 41

NUMBER OF PERSONAL FINANCE LICENSEES AND VOLUME OF LOAN BALANCES OUTSTANDING, GEORGIA, 1934–37[a]

Year	*Number of Licensees*[b]	*Loans Outstanding*	
		Total[c]	Average per Office
1934	58	$4,207,000	$72,534
1935	59	2,560,000	43,389
1936	39	570,000	14,615
1937	8	[d]	[d]

[a] As of December 31st.
[b] Reported by state banking department.
[c] M. R. Neifeld, *Personal Finance Comes of Age* (1939) p. 262.
[d] Not available.

age size of loan office fell 40 percent between 1934 and 1935. The 1936 figure on average size of loan office is of doubtful significance, because some of the reported licensees may not have been operating in that year, as is known to have been the case in 1937. The effect of the rate reduction on the larger lenders is indicated by state banking department information to the effect that the Beneficial Industrial Loan Corporation discontinued in 1936 the 4 offices that it had operated in the state in 1935.

It seems reasonable to assume that total loans outstanding and the average size of loan office were even lower in 1937 than in 1936. Of the 8 licensees reported in 1937, only one company actually confined its business to that of licensed small loans, and this organization is not representative of commercial lenders generally: it is well endowed, has no shareholders, and because of the philanthropic bent of its owner does not need to operate at a profit.

Some formerly licensed lenders now conduct an extra-legal business. One large chain alleges that an applicant for a loan of $100 pays a fee of $2 and executes a note for $108, getting $92 in return, and that this debt is amortized monthly over a period of a year, thus bringing the total charge to about 3½ percent per month. Other lenders engage in a pseudo building and loan business, charging 8 percent interest discounted in advance, and a fee of 2 percent of the face amount of the note; in addition, the borrower is required to buy shares of the lender's stock at a premium of $1.50 per $50 share, and the debt is retired when the borrower completes the monthly payments on the stock and delivers it to the lender. Salary buyers have increased in number, and their charges often exceed 100 percent per year.[12]

Thus in Georgia a very low maximum legal rate has within

[12] Consumer Credit Institute of America, *Report on the Small Loan Situation in the State of Georgia* (1938).

a few years created conditions under which few licensed lenders are willing to operate.

RATE CHANGES IN TENNESSEE

Before February 1937 Tennessee's small loan statute provided for a maximum interest charge of 6 percent per year and a fee for "investigating the moral and financial standing of the applicant, investigating the security, titles, etc., and for other expenses and losses of every nature whatsoever, and for closing the loan"; the fee was not to exceed 3 percent per month of the principal sum lent, and both interest and fee were to be computed on unpaid balance due at the end of each month over the life of the loan. In February 1937 the law was revised and the rate changed. The 6 percent interest charge was continued, but the fee was reduced from 3 to 1 percent per month. This change amounted, in effect, to a reduction from 3½ to 1½ percent per month on unpaid principal balance.

Table 42 presents estimated figures on the personal finance

TABLE 42

NUMBER OF PERSONAL FINANCE LICENSEES AND VOLUME OF EMPLOYED CAPITAL AND OF LOANS MADE, TENNESSEE, 1936–38[a]

Year	*Number of Licensees*[b]	*Employed Capital*[c]		*Loan Volume*[c]
		Total	Average per Office	
1936	57	$3,702,834	$64,962	$5,500,000
1937	12	471,454	39,287	700,000
1938	6	182,000	30,333	[d]

[a] In 1936 and 1937, as of December 31st; in 1938, as of June 30th.
[b] Joseph Frank, *Consumptive Credit Institutions in Tennessee*, unpublished Master's thesis, Vanderbilt University.
[c] Edmund Mottershead's estimates for Consumer Credit Institute.
[d] Not available.

business in Tennessee. After the rate reduction in 1937 many licensed lenders sold out to liquidating companies or stopped lending; by the end of that year the number of licensees was only 21 percent of the number operating in 1936, and by June 30, 1938, it was only 10.5 percent. In 1937 capital invested in the industry was only 13 percent of its 1936 volume, and in 1938 it had fallen to 5 percent; the average capital employed per office declined correspondingly, though not nearly so sharply. According to estimates of the Consumer Credit Institute the total volume of loans made during 1937 was about 13 percent of the 1936 figure. It thus appears that the rate reduction in Tennessee was sufficient to cause drastic decreases both in the number of licensed lenders and in the volume of business conducted.

RATE CHANGES IN MISSOURI

In Missouri a reduction of the maximum legal rate from 3½ to 2½ percent per month became effective on August 29, 1929. The effects of this change differed from those produced in other states by rate reduction, because the Missouri small loan law had been in effect for only two years and the business was still growing rapidly when the rate was reduced, and also because the level to which rates were reduced was not so low as that in any other state we have discussed.

The number of licensees decreased from 174 in 1928 to 95 in 1931.[13] The volume of outstanding loans, however, which had increased from about $6,100,000 in 1928 to almost $10,500,000 in 1929,[14] continued through 1931 at about its

[13] Pennsylvania report, *op. cit.*, pp. 12-13.

[14] The 1929 *Summary of Annual Reports of Personal Finance Companies of Missouri* reports that 27 companies were in business for only part of the year 1929, or failed to make complete reports. The loan balances of these companies amounted to $365,000. Even if this figure is deducted from the loan figure for 1929, it is evident that the personal finance business was growing rapidly in Missouri just before the rate cut, and did not notably decline until about two years after the cut.

1929 level, fell in 1932 to $8,400,000 and in 1933 to less than $7,200,000, but rose by 1937 to nearly $10,200,000.

The average size of loan office, as measured by average loan balances outstanding, was increasing rapidly before the rate change: in 1928 it was $35,000 and in 1929, when the rate change occurred, the 107 offices remaining in business throughout the year had an average loan balance of $94,000. By 1931 the average size had increased further to $125,000, and it fluctuated between $83,000 and $97,000 from 1932 to 1936.

The average size of loans made in Missouri increased immediately after the rate reduction, rising from $122 in 1928 to $153 in 1931,[15] but it showed a slight tendency to decline in subsequent years. This would seem to indicate that although lenders may have refused loans of less than $100[16] they did not turn away $150 loans. The rate reduction was not drastic enough to cause lenders to restrict themselves mainly, as in New Jersey, to loans of $200-300, but it has been suggested that borrowers of very small sums were forced to resort to illegal lenders.[17]

The experience of Missouri shows, then, that the effects produced by reduction in the maximum legal rate will vary according to the stage of development that the personal finance business has achieved when the rate change takes place. The data suggest also that a reduction of the legal rate

[15] Rolf Nugent, "Three Experiments with Small Loan Interest Rates," *Harvard Business Review*, vol. 12 (October 1933) p. 45.

[16] The Pennsylvania report, *op. cit.*, p. 13, states that in Missouri "those lenders who remained in business practically eliminated loans of $100 or less."

[17] The Commissioner of Finance made the following statement in the 1933 *Summary of Annual Reports of Personal Finance Companies of Missouri* (p. 3): "We are aware of the continued existence of high rate, unsupervised agencies, due primarily to the natural demand for loans in small amounts. This demand is being filled at the present time by loan sharks because of the lack of sufficient return on the investment of the regulated licensees to induce them to make loans of smaller amount. It is possible that remedial legislation permitting a higher rate on loans of smaller amounts, $100 or less, would be advisable and serve to eliminate these unlicensed lenders."

from 3½ to 2½ percent affects the small loan business much less than a drastic reduction such as took place in New Jersey.

In 1939 the Missouri law was revised by adding a section outlawing wage buying and increasing the rate to 3 percent on loans of $100 and less.

CONCLUSIONS CONCERNING CHANGES IN MAXIMUM LEGAL RATES[18]

Although there is some variation in the experiences of the states analyzed above, there is sufficient similarity to warrant a few generalizations as to the effect of changes in maximum legal rates on the personal finance business. In all instances it is necessary to bear in mind that it is rate changes from one specific level to another that are in point, and that the effects of any given change doubtless vary according to the level from which the change is made and according to the extent of change.

First, in every case, the number of licensed lenders doing business in the state decreased after a reduction in the maxi-

[18] *Note by W. L. Crum, Director*—This chapter has implied that it is a mistake for maximum charges to be reduced by legislation below a fairly high level. Evidence is presented that such rate reductions have in the past had one or more of the following effects: driving licensed firms out of business; driving customers across state borders; and encouraging unlicensed lenders to do business at exorbitant rates. One question suggested to me by these indicated conclusions is whether the general practice of imposing fairly high maximum rates by state law does not force borrowers with good credit records to pay the same rates as less reliable borrowers, since under present methods of rate control lenders, in order to develop sufficient volume, must encourage loans to poor credit risks. The costs of investigation and the credit losses on such risks are relatively high, and must be borne in part by borrowers whose credit rating is good; in other words, they must provide insurance for those whose rating is poor.

Another question, perhaps even more fundamental, is whether small loan credit might not be granted on a more equitable basis if state regulations did not set maximum rates at all but employed other devices—publicity of accounts, detailed publication of bases of lending, adequate information to borrowers about terms, refusal to enforce contracts involving pledge of collateral unless regulatory requirements had been met—with a view to allowing borrowers whose credit is good to benefit from moderate rates. It seems to me that rates of charge should be so arranged that such borrowers will not be

mum legal rate. If this means a removal of offices to other states the adjustment is obviously less difficult for chain lenders than for individual licensees. There was some tendency for the number of licensed lenders to decline most sharply in those states making the most severe reductions, but the experiences of the various states are not strictly comparable because the market for loans varies in the different states, the different rate reductions were in effect for varying periods of time, and the number of licensees operating immediately prior to rate reduction varied considerably.

Second, the volume of outstanding loans declined after the rate reduction in all states except Missouri, where the effect was indeterminate because the reduction was not to such a low level and because the personal loan business had been legalized for only two years before the change took place, and the industry was still in a stage of rapid growth. In this respect too, however, the different conditions prevailing in the different states made for varying degrees of response to the changes.

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forced to carry part of the cost incurred on loans to poor-risk borrowers. I feel the more strongly about this because a substantial amount of the loans appear to be for expenditures which might reasonably be called postponable, rather than for actual emergencies.

Authors' Comment—The questions raised by Dr. Crum have not been specifically dealt with in the present chapter, but they have been considered elsewhere in the book. It has been pointed out that the maximum legal rate is not necessarily the rate actually charged on all contracts (p. 124), and that lenders do differentiate to some degree among their customers, as is evidenced by the lower terms quoted to borrowers of superior credit rating (p. 68, also p. 156 below).

In regard to the suggestion of other devices than rates as a means of insuring a more equitable extension of small loan credit, it has been mentioned that such devices exist. The Uniform Small Loan Law, under some variation of which lenders operate in a number of states, provides for the regulation of several phases of lenders' activities in addition to the rates which they may charge (pp. 32-33); it requires, for example, that annual reports be filed with a state supervisory body and that clear statements of loan terms be given to borrowers, and it provides for other devices of the type mentioned by Dr. Crum.

There are no reliable data to indicate exactly what proportion of loans are made to finance postponable expenditures as compared with those that are non-postponable (pp. 60-65).

Third, the effect on the average size of loan office, as measured by loans outstanding, varied in the different states: the average size of office increased in New Jersey but decreased in Georgia and Tennessee (measured here by employed capital); in Missouri and West Virginia it increased and subsequently fell. These results may be misleading, however, because they have been obtained by dividing the total volume of loans by the number of licensees reporting, and it may be that some of the reporting licensees were not actually engaged in making small loans. To the extent that this was the case the figures on average size of office are understated. The figures on total volume of loans outstanding (or of capital employed) are more significant.

Fourth, in those states for which data are available the average size of loan tended to increase after the maximum legal rate was reduced, indicating that at the lower rates lenders do not make as many loans of smaller amount. The effect of this on the borrowers of small amounts is to force them to seek funds elsewhere, either from other consumer credit agencies or from unlicensed lenders.

On the other hand, an increase in the maximum legal rate was followed, in West Virginia, by increases in the number of licensed lenders, in the volume of loans outstanding, and in the average size of loan office. In New Jersey the rate increase was not followed by an increase in the number of licensees, but there was a rise in the volume of outstandings, and also a decline in the average size of loan. The fact that the number of New Jersey licensees was not restored to the level it held before the rate cut can be explained by the financial and other requirements of the 1932 small loan law.

8

Relations Among Lenders

It is broadly true that in all lines of business common interests provide grounds for the development of cooperative relations among individuals and firms. In the personal finance business the special statutes that exempt licensed lenders from the usury laws, and the possibility of change in the provisions of these statutes, have given a particular impetus to the development of cooperative relations of the trade association type. In order that small loan statutes which will enable licensed lenders to operate on a profitable basis may be initiated and maintained it is very desirable that the business present its case to public opinion through some kind of cooperative association. This need for joint effort, and also the undeniable public concern about the subject of consumer indebtedness and the institutions immediately connected with it, necessitate a certain degree of self-policing which further encourages the establishment of cooperative relations in the small loan business. On the other hand, the nature of the business is such that a high degree of competition has developed among licensed lenders themselves. Also, they find themselves, singly or collectively, in increasing competition with other kinds of consumer financing agencies.

COOPERATIVE RELATIONS

Cooperative relations among personal finance companies have arisen primarily from attempts to foster the demand for small loans, to protect the interests of lenders collectively, and to supply to individual lenders those services that can best be

provided by concerted action. There are three general types of association, national, state and local in scope, that have been organized to meet these needs.

The need for some national organization to facilitate co-operative relations among lenders was recognized fairly early, doubtless from contacts established at frequent legislative hearings, and in 1916 the American Association of Small Loan Brokers was formed for this purpose. The first important activity of this body was its cooperation with the Russell Sage Foundation in drafting the Uniform Small Loan Law.[1] Subsequently the name of the organization was changed to American Industrial Lenders Association, and in 1929 the present name, American Association of Personal Finance Companies, was adopted. The Association is located in Washington, D. C., and is the only national trade association in the personal finance industry.

The constitution of this group provides that all persons, firms and corporations extending credit subject to regulation by small loan laws are eligible to join as "regular members," those operating more than one loan office being eligible for one regular membership for each office. In addition any person, firm or corporation not acceptable as a regular member but "subscribing to and advocating" the purposes of the Association is eligible for associate membership. About one-third of all reported licensees are members, the number having increased from 951 in 1929 to 1,417 in 1938, but members of the group hold approximately three-quarters of the total volume of outstanding loans. Only regular members have voting privileges, each being entitled to one vote for each membership held. Dues, levied on each regular membership, are determined every year by the Board of Directors as a percentage of average loan balances outstanding during the previous year. Associate members are charged $10 a year.

[1] L. N. Robinson and Rolf Nugent, *Regulation of the Small Loan Business* (1935) pp. 111-17.

The main object of the American Association of Personal Finance Companies is to elevate the standards of business conduct in the trade and to develop a more favorable public attitude toward licensed lending. The importance of these functions derives from the history of the small loan business, which, as has been pointed out, had its genesis in illegal lending. Even after the advent of legislation the attitude of the public and the actions of certain lenders were still reminiscent, in some ways, of conditions that prevailed formerly.

In order to give direction to its policing functions the Association adopted in 1931 a code of ethics setting forth certain standards of business conduct. The code declares that the purpose of the industry is to extend loans for constructive and emergency purposes, and that members of the industry are to cooperate with authorities responsible for the enforcement of small loan laws. In addition, it is required that "members will explain fully to customers the actual cost, terms and contractual obligations of loan transactions," and "will use written instruments as simple, lucid, and unambiguous as circumstances will permit." It is further stated that foreclosures are to be kept at a minimum and that members are to "adhere to generally accepted standards of business deportment in competitive relations, in advertising, and in their dealings with the public."

The public relations activities of the Association consist mainly of issuing pamphlets explaining the operations and economic functions of the industry, and in publicizing the point of view of the lenders when their interests are attacked. The Association also publishes a monthly magazine (*Personal Finance News*) covering matters of interest to members, and in various ways it serves in an advisory capacity on matters of lending practice.

A *Roster of Personal Finance Companies*, published annually by the Association, contains the name and address of every known licensee, thus enabling lenders to avail them-

selves of an indirect kind of collection service: if a customer moves out of the state a licensee can request a lender in the region where the borrower is newly settled to collect the account. Members provide this service for one another without charge. A list of credit information exchange bureaus, which is also included in the *Roster*, enables lenders readily to locate possible sources of information about loan applicants.

Another activity of the Association is the maintenance of an advertising committee for information and advice to members. This committee also maintains a watch on the advertising activities of other consumer credit agencies in order to see that the small loan industry is not adversely affected.

The American Association of Personal Finance Companies provides in its constitution for a National Council, the function of which is to maintain contacts between the national association and the various state associations. The National Council consists of the officers and chairmen of the national association's standing committees, and also representatives of the state associations. National Councilors keep the Association informed on the general condition of the personal finance industry in their respective states, and on the important policies and actions of their state associations, at the same time keeping state associations informed as to the policies and actions of the national association.

In August 1938 there were 27 voluntary state cooperative associations of licensed personal finance companies. With the exception of the Ohio association these do not employ paid officers, and their function is to carry out, on a state-wide scale, activities similar to those of the national association.[2] The state association represents the licensed lenders at legislative hearings in the event of a proposed reduction in the maximum legal rate, the national association leaving this responsibility to the association of the state directly involved.

[2] They are often assisted in their association activities by the paid public relations workers of the larger chain lenders.

The state association also acts to police its members, and lenders who violate the code of ethics drawn up by the national association are subjected to considerable pressure, both from the association and from its individual members.

The third type of cooperative body, the local organization, is made up of licensed lenders who act together mainly for the purpose of establishing and maintaining a credit information exchange bureau. This is a service of particular importance to lenders, not only because of its bearing on the maintenance of adequate credit standards but also because the spirit of the Uniform Small Loan Law is that no borrower should be indebted to personal finance companies at any time for more than $300. At times the local groups also serve as collection agencies when the customers of licensees move from one city to another.

COMPETITIVE RELATIONS[3]

Of the many forms in which competition expresses itself in this business, the most important from the consumers' viewpoint is probably the rate charged for credit services. In the personal finance business the upper limit to rates that can be charged by licensees is set by the provisions of the various state small loan laws. There is a tendency for rates charged by lenders to approach the legal maximum, but competition among lenders is reported to bring rates below this level in some localities and to ease certain other terms of the loan contract.[4] For example, in a state with a maximum 3½ percent flat rate a company may be found to be charging 3 percent on

[3] For a more detailed discussion of competition in the field of consumer credit, with particular reference to personal finance, see T. O. Yntema, "The Market for Consumer Credit: A Case in 'Imperfect Competition,'" American Academy of Political and Social Science, *Annals*, vol. 196 (March 1938) pp. 79-85.

[4] The Pennsylvania Banking Department *Report on Small Loan Companies* (February 1937) states that in 1935, although the Pennsylvania maximum legal rate was 3½ percent per month on unpaid principal balances, the average rate charged was 2.89 percent (p. 20).

the first $100 of each balance, 2 percent on the second $100, and 1 percent on the remainder. Price concessions may be made also on preferred risk loans, the most frequent example of this type being teacher loans, on which the rate may be a flat 2 or 2½ percent although the legal maximum is 3 or 3½ percent. The general willingness to make price concessions of this kind is indicative of the lower cost incurred on such loans, and of the desire of licensees to increase the proportion of their funds invested in these directions.

Competition may also take the form of concessions on the non-price conditions of the loan contracts; easier periods of payment, waiving of security demands, less burdensome collection procedures and other inducements may be adopted. The speed with which loans are made, and the confidential character of the lending arrangements, are often cited by companies as differential advantages that borrowers should take into consideration in choosing a lender.

Another form of competition is the amount of money that will be advanced to any one borrower. In general, the larger the loan carried by any given individual the greater the chance of default, unless the borrower's income is relatively high, but some lenders are willing to take the additional risk in order to increase their loan volume, and thus they will offer a larger loan, relative to the borrower's income, than will other lenders. Other less direct forms of competitive effort manifest themselves in advertising practices, including efforts to gain the most convenient and attractive location for loan offices.

Competition between personal finance companies and other similar agencies, such as industrial banking companies, the personal loan departments of commercial banks, and sales finance companies, is becoming increasingly important. In most states commercial banks and industrial banking companies are allowed to make larger loans than personal finance companies, but they have actively entered also into the lend-

ing of amounts up to $300. The credit services extended by sales finance companies are also in many ways comparable with those offered by the personal finance companies, although the form of the borrower-lender relationship may tend to hide the similarity.

In all agencies engaged in consumer lending the trend of development seems to be toward greater diversification of credit activities. Thus a company making cash loans may in addition encourage borrowing to finance a commodity purchase, or may operate a sales finance affiliate or subsidiary; a sales finance company, through special offices or affiliated companies, may actively engage in the small cash loan business; and commercial banks are likely, if they set up a personal loan department, to diversify their business as far as possible. As a result there is a complicated competitive situation among the agencies supplying consumer credit: companies that might operate in fairly distinct markets, if it were not for this general diversification of activities, find themselves offering, in effect, the same services to substantially the same market.

Finally, where maximum legal rates are low there is a certain amount of competition between licensed and unlicensed lenders—particularly in regard to middle-size loans, since the licensed lenders cannot afford to grant many smaller loans and the high rates of the unlicensed lenders cannot attract many borrowers of larger sums. And in such states the licensed lenders may also have to face the competition of licensed lenders in neighboring states where the laws permit higher rates; after the rate reduction in New Jersey, for example, many lenders, as was mentioned above, moved to nearby towns in Pennsylvania and continued to make loans to New Jersey customers in competition with the small loan companies that had remained in that state.

Certain characteristics of the personal finance business doubtless serve to limit the degree of competition prevailing

in this field. The loan office itself is distinctly local in its operations, serving a necessarily limited market; it is impossible for a large number of licensees to operate in one locality and thus create any high degree of competition. The number of offices in a single community is also influenced in certain states by small loan legislation that instructs supervisory authorities to limit the granting of licenses to suit the "convenience and advantage of the community."

It is questionable, however, whether rate competition among many offices in a community would be as likely to lead to lower rates as would competition among only a few offices. If the number of offices in a community is small, and hence the average size of office relatively large, the resultant economies of operation may stimulate a more severe rate competition than would be the case if offices were of relatively small size. In some states the legal limitation as to number of offices in a community makes it possible for the average size of office to increase rapidly without recourse to aggressive competition.

It is not possible, however, to make statements of general validity on these points. The form and extent of competition, or the lack of it, are determined by the special circumstances attending specific situations. The effects of rate competition depend on the amount of the rate cut, the extent to which the cuts are met by other lending agencies, the amount of advertising and general sales promotion effort which accompany the rate change, and the period of time over which the lower rates are maintained. From the point of view of business profits the desirability of rate cutting depends on the resultant changes in total receipts and in costs of operation; and the nature of the market is such that a short-run rise in total receipts from increased borrower demands at lower rates is not to be expected. In certain circumstances, such as a situation of impending legislative action aimed at further regulation of the small loan business, rate cuts might be considered advan-

tageous even if they did not result in an increase in total business receipts.

The character of the borrower-lender relation is such that small changes in rates are unlikely to cause borrowers to shift from one lender to another,[5] although a substantial rate cut may have this effect, increasing the volume of business done by the rate cutting firm at the expense of its competitors. It might be noted that the shifting of borrowers from one lender to another does not necessarily wait upon the normal paying out of a given borrower's account over the contractual period. There is apparently a good deal of paying off of loans from one lender by means of funds borrowed from another lender, but there is no evidence to indicate the extent of this practice.

The method of quoting rates on small loans often confuses borrowers and renders difficult a comparison of terms offered by different licensed lenders, particularly in those few states where it is permissible for small loan companies to charge fees. Borrowers have even greater difficulty in comparing terms offered by different types of consumer credit agencies, and competition would doubtless be increased considerably if all agencies quoted terms on a uniform basis, either in dollars or in percent.

A final aspect of the competitive situation in the small loan market is the interchange of credit information among various lenders. Undoubtedly, both from the social point of view and from that of the individual lender, a complete interchange of information on the instalment-debt position and record of the individual borrower is greatly to be desired. Under such conditions the costs of investigation and the risks of lending would be reduced substantially, and the likelihood of any given borrower receiving a total of credits in excess of his capacity to pay, thus involving himself in severe financial straits, would largely be obviated. The possession of credit information, however, is sometimes viewed by individual lend-

[5] See T. O. Yntema, *op. cit.*, p. 83.

ers and by groups as an important asset, not to be shared with competitors. In fact, personal finance companies publicize widely the private or confidential treatment they accord all loan applications, implying that borrowings will not be disclosed to any agency, employer or other person who might use the information to the borrower's detriment, at least in the latter's judgment. Consequently the growth of an adequate interchange of credit information between personal finance companies and other agencies has been inhibited, though such interchange has developed to a certain degree among personal finance companies themselves. Moreover, the intensification of competition among various types of consumer credit agencies during recent years has tended to the breakdown of previously well-established credit information agencies. The situation varies, of course, in different communities; some have very complete agencies while others are almost entirely lacking in such facilities.

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